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RATIONALIZING THE DISCLOSURE PROCESS: THE SUMMARY ANNUAL REPORT

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In 1986 the staff of the Division of Corporate Finance of the SEC issued two letters approving the use of a summary annual report. These letters have acceded to management a great amount of discretion in connection with the annual report. The summary annual report costs less to produce than the conventional annual report and a decision about its use may encourage a re-examination of the shareholder communication process. However, uncertainty exists over whether the summary annual report will implicate concerns under the securities laws.

EVERY SPRING, most corporations engage in the modern day version of the town meeting. In accordance with state law,¹ these corporations at least annually convene a meeting of all their shareholders. The meetings provide a forum not only for electing directors and approving accountants, but also for questioning management about high salaries, generous options, and other concerns which may arise.

Although often colorful, the annual meeting has become largely a formality.² Unable or unwilling to attend the meeting in

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1. State law generally requires corporations to hold meetings of shareholders on an annual basis. See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (1953).

2. Annual meetings provide an opportunity for gadflies and other corporate neo-

person,³ most shareholders exercise their franchise through the proxy process.⁴ Given the importance of this process, it is not surprising that proxy solicitations have been subject to substantial regulation. In addition to minimal regulation under state law,⁵ the Securities and Exchange Commission (SEC) has adopted a comprehensive set of rules governing the proxy process.⁶

The proxy rules attempt to ensure that shareholders have sufficient information to make informed decisions when executing their proxies. Publicly traded companies⁷ that solicit proxies must

phytes to wax poetic about various issues. See Hughes, *Wickes Cos. Holders Vent Their Anger Over Stock's Plunge*, Wall St. J., June 23, 1988 at 16, col. 3 ("Angry Shareholders of Wickes Cos. begged Ming the Merciless to become Ming the Merciful at the company's raucous annual meeting.").

3. With the growth in the number of shareholders, attendance at meetings has been impractical and, perhaps, undesired. As one court noted: "It would be stupid indeed to assume that eight thousand shareholders may possibly attend the meeting in person It would require 'Boyle's thirty Acres' to accommodate them." *Berendt v. Bethlehem Steel Corp.*, 108 N.J. Eq. 148, 151, 154 A. 321, 322 (N.J. Ch. 1931). See also *Mackin v. Nicollet Hotel*, 25 F.2d 783 (8th Cir. 1982).

The old theory which seemed to dominate the earlier writers to the effect that every stockholder in a corporation is entitled to have the benefit of a judgment of every other stockholder in the selection of a board of directors, has necessarily been rendered obsolete because of our modern business being conducted by large corporations with thousands of stockholders located in all parts of the country. Manifestly a meeting of the stockholders of such organizations would be not only impracticable but impossible.

Id. at 786.

4. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1490 (1970) ("It is well known that proxy voting has become the dominant mode of shareholder decision making in publicly held corporations."). See also J. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE UNITED STATES, 1780-1970*, at 94 (1970) ("The core reality of stockholder suffrage in the big company lay in the use of proxy machinery."); SECURITIES AND EXCHANGE COMMISSION, 77TH CONG., 1ST SESS., REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934-35 (Comm. Print 1941) ("Ownership of securities is so widely diffused that voting by stockholders in corporate meetings is today affected almost entirely by proxies.").

5. Some states did impose a few, ineffective restrictions on management's use of proxies. For instance, salaried officers were not permitted to become proxyholders. Early statutes also limited the number of shares that a proxyholder could vote. See Dodd, *Statutory Developments in Business Corporation Law*, 50 HARV. L. REV. 27, 33 (1936). Nonetheless, over time, state law ceased to impose any real limits on management's use of the proxy process. *Id.* at 35 (noting that the 1903 revisions of the Massachusetts corporate code "marked the end of any attempt . . . to put obstacles in the way of control of the proxy machinery by the management").

6. See 17 C.F.R. §§ 240.14a-1 to .14b-2 (1988). For a discussion of the mechanics of the proxy rules, see Goelzer & Brown, *Preparation of Proxy Materials*, in MEETINGS OF STOCKHOLDERS 49 (1987).

7. In general, publicly traded refers to those companies with a class of securities registered under section 12(g) of the Securities Exchange Act of 1934 (current version at

provide shareholders with a proxy statement which discusses the proposals to be presented at the meeting, and any harmful impact resulting from their approval.⁸ Prior to the annual meeting at which directors will be elected, management must also supply shareholders with an annual report, which contains financial and other information needed to assess the company's performance over the past year.⁹

The proxy rules, however, may not always advance the interests of shareholders and management by requiring disclosure through two separate documents — a proxy statement and an annual report. Under this bifurcated disclosure process, a shareholder may need to search both documents to uncover the facts needed to intelligently execute the proxy. The two-document requirement also raises complex timing problems.¹⁰ Because the documents are often mailed separately, shareholders are sometimes forced to execute a proxy without having both documents present. Finally, extensive SEC regulation of the contents of annual reports, through the proxy rules, has impaired the effectiveness of the document as a device for communicating with shareholders. Content regulation not only has eliminated much of management's drafting flexibility but also has increased costs.

Perhaps in recognition of these problems, the staff of the SEC's Division of Corporation Finance has taken a major step toward harmonizing the Commission's goal of ensuring meaningful disclosure in the proxy process with management's desire to communicate with shareholders through a report unfettered by form and content rules. In early 1986, the staff issued two letters approving the use of a *summary* annual report.¹¹ These letters indicated that the information normally required in the annual report

15 U.S.C. § 78l(g) (1986)), or traded on an exchange under Section 12(b) of the Securities Exchange Act of 1934 (current version at 15 U.S.C. § 78l(b) (1986)). Companies filing a registration statement are subject to the periodic reporting requirements, but not the proxy rules. *See* Section 15(d) of the Securities Exchange Act of 1934 (current version at 15 U.S.C. § 78l(d) (1986)).

8. *See, e.g.*, Disclosure in Proxy and Information Statements; Anti-Takeover or Similar Proposals, Exchange Act Release No. 15,230, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,748 (Oct. 13, 1978) (requiring disclosure of disadvantages of anti-takeover charter and bylaw amendments).

9. 17 C.F.R. § 240.14a-3(b)(1) (1988).

10. *See infra* notes 20, 125-27 and accompanying text.

11. McKesson Corp., SEC No-Action Letter (May 15, 1987) (LEXIS, Fedsec library, Noact file); General Motors Corp., SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,401 (Jan. 20, 1987).

could instead be appended to the proxy statement. Once this appended statement had been issued, companies were free to distribute to shareholders a summary report containing condensed financial information. Therefore, shareholders would receive both a single, integrated proxy statement, containing all of the information needed to execute a proxy, and a simpler, more readable summary annual report.¹²

The staff position represents a throwback of sorts. In 1942, the Commission proposed the use of a single, integrated proxy statement that included financial information, but abandoned the proposal in the face of withering opposition.¹³ The position also provides immediate benefits. The two staff letters offer management substantial additional flexibility in determining the contents and format of the report, which may result in a more effective and comprehensible, but less expensive, document. The staff's rationale, logically extended, would also permit companies to dispense altogether with the annual report to shareholders. Thus, both the contents of the report and the need to send one in the first instance will no longer depend upon the prescriptions of the proxy rules but upon business and corporate communication considerations.

Although representing a major advance, the staff position raises concerns. Because this new format was announced in two staff letters, the analysis represents the position of a single division rather than that of the whole Commission.¹⁴ Indeed, the Commis-

12. The concept of a summary annual report has caused confusion. A normally informed periodical like the Wall Street Journal inaccurately reported that "the summary [annual] report must include a full profit-and-loss statement and balance sheet and a management analysis of major business risks and liabilities." Berton, *Best Foot Forward*, Wall St. J., Sept. 9, 1987, at 1, col. 6. The statement is incorrect. The staff's two letters indicate that the amount of financial information in a summary report is up to management, subject only to the limits imposed by the antifraud provisions. See *infra* notes 163-246 and accompanying text.

13. See *infra* notes 43-49 and accompanying text. Nothing in the Commission letters indicates any conscious effort to resurrect, or even awareness of, the 1942 proposals.

14. See Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019 (1987); see also Professional Care Services, Inc., SEC No-Action Letter, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,770, at 84,080 (Mar. 15, 1974) ("The staff responses in no-action letters only purport to represent the views of the officials who gave them."). The use of letters to espouse a novel interpretation of the proxy rules is somewhat of a surprise. As practitioners know, revisions of the proxy rules are carried out annually. The SEC issues releases to announce the revisions and normally avoids no-action letters for deviations. This practice persists. For instance, the Commission has issued several recent releases proposing amendments to, or adopting changes in, the proxy rules. See Amendments to Eliminate Filing Requirements for Certain Preliminary Proxy Material; Amendments with Regard to

sion has not formally reviewed the letters. Consequently, both letters lack the force of rules adopted pursuant to the notice and comment procedures of the Administrative Procedures Act.¹⁵ The Commission could, with little difficulty, reverse the staff's position. Moreover, the staff could abruptly abandon its position with little notice. The staff of the Division of Corporation Finance has itself added to the uncertainty by deciding not to review further requests in the area.¹⁶

The summary annual report also raises concerns under the antifraud provisions.¹⁷ In addition to Rule 10b-5,¹⁸ summary annual reports may be subject to Rule 14a-9, the antifraud provision of the proxy rules.¹⁹ The reduced disclosure in summary annual reports heightens the likelihood that a court will find the report incomplete or misleading. Under such circumstances, the issuer may need to rely on the fuller disclosure contained in other publicly filed documents to avoid incurring liability for incomplete or loose statements made in a summary annual report. Whether accurate financial statements in the Form 10-K or the proxy statement will fully compensate for abbreviated and arguably misleading disclosure in the summary annual report will depend upon the facts and circumstances of each case. Thus, while holding substantial promise, use of the summary annual report likewise presents substantial risk.

I. BACKGROUND

The proxy rules contemplate that once a year companies will distribute an annual report to shareholders. Rule 14a-3(b) requires the distribution of the report in advance of the annual

Rule 14a-8, Shareholders Proposals, Exchange Act Release No. 25,217, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,211 (Dec. 21, 1987); Proxy Rules — Amendments to Conform to Comprehensive Proxy Revisions, Rules Providing for Modified or Superseded Documents, Exchange Act Release No. 24,514, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,130 (May 27, 1987); Facilitating Shareholder Communications, Exchange Act Release No. 24,274, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,113 (Mar. 27, 1987).

15. 5 U.S.C. §§ 551-706 (1986).

16. Business Wire, June 1, 1987 ("Fearing an avalanche of requests for approval of variants to the GM/McKesson approach that would distract the SEC's staff from other possible business, the commission has since refused to review any further variations.").

17. See *infra* notes 193-236 and accompanying text.

18. 17 C.F.R. § 240.10b-5 (1988).

19. 17 C.F.R. § 240.14a-9 (1988).

meeting at which directors will be elected.²⁰ The annual report must be sent either prior to, or concurrently with, the proxy statement. More than just a timing provision, Rule 14a-3(b) also prescribes the content of the annual report. An annual report must include, among other things, audited financial statements and other financial information, management's discussion and analysis of that information, a description of the company's business industry segments, share price and dividend information, and background information on all executive officers and directors.²¹ Typically, more than half of the document consists of required information.²² Rule 14a-3(b), therefore, ensures that shareholders will have the full financial and narrative disclosure contained in the annual report when executing a proxy.

A. Evolution of the Annual Report

The existing regulatory scheme for the annual report emerged largely by accident, the result of successive revisions of the proxy rules without a clear consideration of their fundamental purposes. Commission regulation of annual reports arose in an effort to harmonize disparate disclosure regimes. Prior to adoption of the Securities Exchange Act of 1934,²³ corporations often distributed annual reports to shareholders. Some companies did so pursuant to state law,²⁴ while others did so in accordance with the rules of the New York Stock Exchange.

The New York Stock Exchange began requesting reports in 1866.²⁵ In 1895, listed companies were strongly urged to issue annual earnings sheets and balance reports, with the urging becom-

20. 17 C.F.R. § 240.14a-3(b) (1988).

21. *Id.*

22. According to one study, elimination of the required financial information reduced the annual report by about half. 1 S. GOLUB & J. KUEPPERS, SUMMARY REPORTING OF FINANCIAL INFORMATION 1 (1983).

23. 15 U.S.C. §§ 78a-kk (1986).

24. See Comment, *Statutory Developments in Business Corporation Law*, 1886-1936, 50 HARV. L. REV. 27, 37 (1936).

The earlier provision [requiring] annual reports was continued [in the 1903 revisions of the Massachusetts corporate code], but instead of leaving the form of the report to be determined by the Commissioner, the new act provided for a form of statement of assets and liabilities so lacking in detail that it was calculated to give little information as to the true state of the corporation's finances. *Id.*; see also Note, *Disclosure of Corporate Affairs*, 47 HARV. L. REV. 335, 337-38 (1933)(states used "Blue Sky" laws and other corporate code provisions to require filing of annual reports).

25. J. HURST, *supra* note 4, at 91.

ing a requirement five years later.²⁶ The Exchange formally required distribution of annual reports to shareholders in 1909.²⁷ Its listing agreement explicitly stated that exchange traded companies must:

publish at least once in each year and submit to stockholders, at least fifteen days in advance of the annual meeting of the corporation, a statement of its physical and financial condition, an income account covering the previous fiscal year, and a balance sheet showing assets and liabilities at the end of the year; also annually an income account and balance sheet of all constituent, subsidiary, owned or controlled companies.²⁸

Thus, at the time of the adoption of the Securities Exchange Act of 1934,²⁹ the distribution of an annual report was a long-standing and widespread practice, at least among exchange traded companies.

The reports, however, often proved inadequate. Without uniform standards for financial reporting and other disclosures, annual reports tended to obscure rather than elucidate.³⁰ Moreover,

26. J. LIVINGSTON, *AMERICAN STOCKHOLDER* 159 (1963). The NYSE sent letters to listed companies requesting that they send "from time to time, as they may be issued, the Reports of your Company. . . to the Secretary of the New York Stock Exchange." *Id.* at 157. The NYSE delisted one company in 1932 for failing to issue an annual report. *Id.* at 159.

27. J. HURST, *supra* note 4, at 91.

28. H. MARTIN, *THE NEW YORK STOCK EXCHANGE* 271-72 (1919); *see also* Note, *supra* note 24, at 336 n.13 (describing materials to be provided to shareholders under the exchange rules). The annual report requirement meant that the shareholders would receive current information only once a year. As early as 1913, Congress indicated the need for more frequent disclosure. H.R. REP. NO. 1593, 62d Cong., 3d Sess. (1913).

[T]he objectionable features of operations on stock exchanges would be eliminated . . . if such exchanges required corporations whose securities are listed by them to file before the listing and thereafter at regular intervals, for public inspection, a verified statement showing item by item their assets and liabilities and income and expenses, and for what their capital stock has been issued, stating how much for property and other considerations, with a description of such property and considerations and a statement of any commissions paid to promoters, brokers, middlemen, or vendors; a verified copy of statement of any contract, whether in writing or parol, in any manner affecting the issue sought to be listed or relating to any interest therein of promoters, bankers, middlemen, or vendors; and a verified statement of any transactions, direct or indirect, between such corporations and their officers and directors.

Id. at 117.

29. 15 U.S.C. §§ 78a-kk (1986).

30. *See* W. RIPLEY, *MAIN STREET AND WALL STREET* 156-207 (1927) (discussing the inadequacies of corporate disclosure). *See also* Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1324 (1934) (noting that annual reports were "distinguished for [their] vagueness and generality and for [their] capacity to conceal and suppress vital

even if accurate, the reports provided only a momentary snapshot of a company's financial condition. Developments during the remainder of the year went unreported.³¹ Additionally, shareholders often received annual reports too late to be of any value in the proxy solicitation process.

In adopting the Securities Exchange Act of 1934,³² Congress did nothing to disturb the existing reporting requirements. Indeed, the Act conferred on the Commission no explicit authority to regulate the annual report to shareholders. Instead, Congress put in place an additional, unrelated disclosure regime. Section 13(a)³³ required the filing of periodic reports with the Commission. Congress obviously expected the information to become available to all interested parties.³⁴ The provision ensured the availability of financial information to the markets, but did not, explicitly or implicitly, require distribution of the reports to shareholders. Section 14(a)³⁵ gave the Commission regulatory authority over the proxy process. While this section contemplates the distribution of information to shareholders, it was intended to be limited to the proxy process. Nowhere does the legislative history of Section 14 suggest that other, unrelated documents should be distributed.³⁶

facts"). The few states that required annual reporting provided minimal content regulations. Comment, *supra* note 24. Nor have modern state statutes been any more effective. See Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964).

A recent check of the corporation laws of the fifty states and the District of Columbia reveals that twenty-two states have corporate reporting requirements of one type or another. Of these, in only fourteen states are the reports available to shareholders, and in three the requirement may be dispensed with by including a contrary stipulation in the by-laws. Specific requirements of content for reports are generally nonexistent, and only two states require certification by a public accountant.

Id. at 625.

31. In 1926, only 242 of the 957 companies listed on the NYSE distributed quarterly reports, while another 70 distributed reports semiannually. W. RIPLEY, *supra* note 30, at 187.

32. 15 U.S.C. §§ 78a-78kk (1986).

33. Securities Exchange Act of 1934 § 13(a) (current version at 15 U.S.C. § 78m(a) (1986)).

34. See S. REP. NO. 792, 73d Cong., 2d Sess. 10 (1934) ("Reports under this bill will provide adequate information reasonably up to date as long as the security is traded on an exchange.").

35. Securities Exchange Act of 1934 § 14(a) (current version at 15 U.S.C. § 78n(a) (1986)).

36. See generally H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934); S. REP. NO. 1455, 73d Cong., 2d Sess. (1934). See also 1 L. LOSS, SECURITIES REGULATION 348 (2d ed. 1961) ("Apart from the Holding Company and Investment Company Acts, the SEC cannot directly regulate the reports sent to shareholders as distinct from those filed under

Nevertheless, Section 14 ultimately proved to be the source of the Commission's rulemaking authority to regulate annual reports. This section granted the Commission almost unlimited authority over the proxy process.³⁷ A year after the adoption of the Securities Exchange Act of 1934, the Commission adopted a rudimentary set of proxy rules.³⁸ The rules did little more than impose minimal disclosure requirements and prohibit fraudulent practices.³⁹ The Commission adopted the rules fully expecting that, with experience, revisions would become necessary. In 1938 revisions mandated distribution of a proxy statement and substantially expanded the disclosure requirements.⁴⁰

Through the 1938 revisions, the Commission seemed primarily concerned with ensuring that shareholders had adequate information to intelligently cast their votes on the specific issues presented at shareholder meetings. Thereafter, the Commission began to focus on the need to supply shareholders with general financial information about the company, particularly when electing directors. This type of information enabled shareholders to better evaluate the company's performance and, concomitantly, the performance of its directors. Although the annual reporting requirements of the NYSE did require disclosure of some financial information, the information was often inadequate and received too late in the proxy process to be of any value.⁴¹ As the

the several statutes.”).

37. “[T]he language of Section 14(a) is broad and quite clearly extends somewhat beyond disclosure although how far is not at all clear.” *The Role of the Shareholder in the Corporate World: Hearings Before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 5 (1977) (statement of Philip Loomis, Commissioner, SEC); see also Comment, *Regulation of Proxy Solicitation by the Securities and Exchange Commission*, 33 ILL. L. REV. 914, 941 (1939) (“Under. . . the proxy rules . . . the Commission exercises a more far-reaching regulation over the solicitation of proxies than is found in the disclosure requirements of the Securities and Exchange Act of 1934.”).

38. Exchange Act Release No. 378 (Class A) (Sept. 24, 1935).

39. See *Proxy Rules: Hearings Before the House Comm. on Interstate and Foreign Commerce*, 78th Cong., 1st Sess., pt. 1, at 14 (1943) [hereinafter *Proxy Hearings*] (“[T]he 1935 rules were extremely rudimentary in nature. They merely prohibited falsehoods in proxy solicitation. They did not govern what persons soliciting proxies should put in their proxy statements.”) (Statement of Mr. Purcell, Chairman, SEC).

40. Proxy Solicitations; Security Holder's Opportunity to Direct How Vote Shall Be Cast, Exchange Act Release No. 1,823, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,151.43, at 24,151.52 (Aug. 11, 1938).

41. See *Proxy Hearings*, *supra* note 39, at 167 (statement of Mr. Purcell, Chairman, SEC) (“The Commission on this proposal was concerned with the fact that there was no provision either in State laws or in the stock exchange rules which required an annual

Chairman of the Commission explained:

Even under the old NYSE rules, the majority of corporations sent their annual reports voluntarily along with their proxy soliciting material and some corporations sent their annual reports before beginning the solicitation of proxies. However, there were a number of companies who first sent out soliciting material and obtained their proxies and then at a later date sent the annual report to the shareholders. That, of course, resulted in obtaining the reelection of the board of directors without telling stockholders how their corporations had been operated during the past year.⁴²

To address this problem and ensure timely receipt of financial information, the Commission opted for a clear, practical solution — all relevant financial information would be included in the proxy statement.⁴³ Shareholders would receive a single integrated document with all the information — including financial — needed to execute a proxy. Moreover, by requiring that financial information be included in the proxy statement, the rationale for a separate annual report evaporated. Not only would shareholders receive all of the needed information in a single document, but companies would no longer have to prepare a second document to distribute to shareholders.

Given the obvious benefits of this solution, the Commission expected its proposal to spell the demise of the annual report. Indeed, the Commission ultimately expected the proxy statement, Form 10-K, and the annual report to be collapsed into a single document.⁴⁴ The proposed rule, however, generated a deluge of

report containing financial statements to be sent to security holders before they executed their proxies.”).

42. *Id.* at 167-68.

43. *Id.* at 168.

44. According to the Commission:

It is anticipated that the proposal will result in considerable simplification and consolidation of reports. At present many corporations are in the habit of preparing three documents: (1) an annual report to stockholders; (2) a proxy statement; and (3) an annual report to the Commission on Form 10-K. Under the proposed rules it will be possible to merge the first two documents If the proposal is finally adopted, the Commission will have an opportunity to permit this document to be filed in lieu of most of the information presently called for by Form 10-K. In that event the single document which is the annual report to stockholders and the proxy statement can also be used as the 10-K report merely by making a few additions in the form of exhibits or schedules. It is appreciated that in some cases reasons of practical necessity will require the mailing of the annual report in advance of the direct solicitation of proxies and the rules make

criticism.⁴⁵ The rule would have resulted in the financial statements becoming "filed" with the Commission, thereby raising the specter of liability under Section 18.⁴⁶ Not yet supplanted by Rule 10b-5,⁴⁷ liability under this section seemed a real concern. Critics claimed that subjecting the financial statements to Section 18 liability would harm shareholders by forcing companies to turn to lawyers to draft the document, with technical precision taking precedence over readability. As one critic concluded:

An increasing number of companies are producing reports which laymen can read and understand and are thus encouraging the interest of stockholders in corporate affairs. Should the statutory liabilities be applied to the annual report, there is great danger that corporate officials will be constrained to turn the draftsmanship over to lawyers and technical men. What the report gains in technical compliance with rules, it will lose in readability. Should it thus become a dry and legalistic document, the revision will have impaired the very purpose which is ascribed to it. It would be far better to permit and encourage the natural evolution which corporate reports are now undergoing.⁴⁸

The criticism had its intended effect. In adopting its final rules, the Commission abandoned the single document concept. Instead, the rules required companies to send annual reports to shareholders prior to, or concurrently with, the proxy statement.⁴⁹

provision for such a procedure. However, it is expected that in most cases the single document can be used.

Id. The Commission distributed about 4,500 copies of the proposed rules and received over 500 written comments.

45. *Id.* at 142-43 (statement of Mr. Purcell, Chairman, SEC)(noting objections lodged by corporate, exchange, and investment banking representatives); *See also id.* at 150 & 154-55.

46. Securities Exchange Act of 1934 § 18 (current version at 15 U.S.C. § 78r (1986)). Section 18 provides a cause of action for fraudulent statements in documents "filed" with the Commission.

47. Rule 10b-5 was adopted in May 1942, only a few months before implementation of final rules regulating the annual report. Exchange Act Release No. 3,230 (May 21, 1942), 7 Fed. Reg. 3804. The current version of rule 10b-5 is contained in 17 C.F.R. § 240.10b-5 (1988). The rule's potential as a device for recovery by private plaintiffs did not begin to become apparent until several years later. *See generally* Speed v. Transamerica Corp., 71 F. Supp. 457, 457-58 (D. Del. 1947)(court noted that an individual right of action for damages from § 10(b) and Rule 10b-5 violations was first recognized in *Harden v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

48. *Proxy Hearings*, *supra* note 39, at 150 (letter sent to Mr. Purcell from various corporate officers and partners offered into the committee record).

49. As the Rule provided:

(b) If the solicitation is made by the management of the issuer and relates to a

The rules represented little more than a timing provision⁵⁰ and did not purport to regulate the content of the report.⁵¹ Although a copy had to be sent to the Commission, the annual report was not deemed "filed" for purposes of Section 18.⁵² As the then Chairman of the Commission explained:

The new rules prohibit this practice and make sure that the stockholder has been supplied with the annual report when he is asked to execute his proxy. The new rules regulate only the time when the annual report is sent. They do not say what must go into the report except that it must contain financial statements

meeting of security holders at which the election of directors is an item of business, an annual report to security holders containing such financial statements for the last fiscal year as will, in the opinion of the management, adequately reflect the position and operations of the issuer. Such annual report to security holders, including financial statements, shall be in any form deemed suitable by the management. If such annual report is sent to security holders in advance of the proxy statement and form of proxy, it shall contain a statement in a prominent place that proxies will be requested at a later time, indicating the approximate date on which the proxy statement is expected to be sent to security holders. In such case the proxy statement shall contain a statement in a prominent place that an annual report to security holders, including financial statements, has been previously sent to security holders, indicating the date on which it was sent. Solely for the Commission's purposes in checking compliance with this rule, three copies of any such annual report to security holders which is not filed under § 240.14a-4(b) [Rule X-14A-4(b)] because it is to be sent out in advance of the proxy statement shall be mailed to the Commission for its information not later than the date on which such report is first sent or given to security holders.

Rule 14a-1(b), 7 Fed. Reg. 10,655 (Dec. 22, 1942) (current version of rule at 17 C.F.R. § 240.14a-1(b) (1988)). The Commission adopted the amendment in Exchange Act Release No. 3349 (Dec. 15, 1942).

50. Even the timing requirement imposed few additional burdens. In the proxy solicitation process, companies often asked shareholders to approve the annual report. *See generally* Opinion of General Counsel Regarding Texts of Proxy Solicitations in Certain Instances; Acknowledgment by Commission of Receipt of Material, Exchange Act Release No. 461 (Jan. 21, 1936). As a result, the annual report had to be received before the proxy materials.

51. In a hearing shortly after adoption of the 1942 revisions to the proxy rules, Congressman Wolverton expressly asked whether the Commission had "any supervision of the contents" of the annual report. Commission Chairman Purcell responded: "None whatsoever." *Proxy Hearings, supra* note 39, at 21.

52. Letter of Director of Corporation Finance Division Regarding Status of Annual Reports Included With Proxies as Part of Proxy Solicitation Material, Exchange Act Release No. 3,380, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,082 (Feb. 5, 1943) (opinion of Director of Division of Corporation Finance that annual report is not a filed document). The modern rule adheres to this same principle. 17 C.F.R. § 240.14a-3(b) (1988). *But see infra* note 55 and accompanying text. The courts have also acknowledged the special, unfiled status of the annual report. *See, e.g.,* Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). In addition, the *Heit* court rejected the argument that filing the annual report with an exchange subjected the document to Section 18 liability. *Id.* at 915.

in any form deemed proper by the management. As you will remember, the requirement as to financial statements is largely a duplication of the existing stock exchange requirements. The change which we made involves no additional work on the part of the corporation. It merely prescribes a time schedule they must follow. To most corporations this involves no change at all. In some instances it has required a postponement of the date of the annual meeting for a few weeks' time at the most. This is a small price to pay for insuring stockholders receive information before rather than after they act.⁵³

Critics gained at best a pyrrhic victory. Although limited in scope, the rules began a gradual process of increased regulation over the form and content of the annual report. Initially concerned only with the timing of the report's distribution, the Commission gradually and incrementally subjected the annual report to greater regulation. Content ultimately ceased to be sacrosanct, with the promulgation of Rule 14a-3 requiring the disclosure of substantial information.⁵⁴ At the same time, the importance of

53. *Proxy Hearings*, *supra* note 39, at 168 (statement of Mr. Purcell, Chairman, SEC). The failure of the Commission to regulate the content of the document often left shareholders with annual reports which contained markedly different financial statements from those filed with the Commission. See Kaplan & Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 YALE L.J. 935 (1939).

A study of balance sheets and income statements appearing in the 1930 and 1937 published reports of seventy large corporations, herein presented, indicates that, despite a marked improvement since 1930, such reports fall considerably below the accounting standards which the same corporation is required to meet in its reports to the SEC and to the exchange on which its securities are registered.

Id. at 938.

Although shareholders could obtain copies of reports from the Commission, the process presented difficulties. *Id.* at 937 ("[The] cost [of duplicating reports] is likely to be prohibitive and the effort to obtain it is so great that only the most self-conscious investor will bestir himself.") Of course, differences in financial statements, distributed to shareholders and filed with the Commission, could give rise to an action for fraud.

54. See Amendment of Reg. § 240.14a-3 and Form 8-A, Exchange Act Release No. 7,508, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,187 (Jan. 15, 1965) (requiring annual report to include discussion of issuer's business); Adoption of Amendment of Rule 14a-3, Exchange Act Release No. 7,324, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,999 (May 26, 1964) (requiring annual reports to include consolidated financial statements); SEC Interpretation of Proxy Rules, Exchange Act Release No. 7,078, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,103 (May 15, 1963) [hereinafter Exchange Act Release No. 7,078] (requiring disclosure in annual report of financial statements of any significant subsidiary). See also Notice of Proposed Amendment to Form 10-K, Exchange Act Release No. 9,576, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,727 (Apr. 20, 1972) (requiring registrants to file with the SEC an itemized list of information which is not included in the registrant's annual report to its shareholders); Kant, *The New*

avoiding Section 18 liability receded as the Rule 10b-5 era flowed. Finally, even absolution from liability under Section 18 ceased, as portions of the annual report became "filed" for purposes of the section.⁵⁵

Commission regulation of the annual report might have been of little moment for issuers already producing the document in conformity with the listing requirements of the NYSE. In 1964, however, Congress amended the Exchange Act to subject issuers in the over-the-counter markets to the periodic reporting requirements and the proxy rules.⁵⁶ For the first time, these issuers became obligated to produce and distribute an annual report to shareholders. Annual reporting requirements were thereby extended to a large class of issuers not already required to issue an annual report by the rules of a self-regulatory organization.

B. Regulation

The annual report largely survived as an unregulated document until the mid-1970s. Although they imposed certain minimal disclosure requirements, the proxy rules essentially continued to regulate only the timing of the document's distribution.⁵⁷ Control over the contents of the report remained in the hands of management. As a result, management could, and often did, vary the financial disclosure contained in the annual report to shareholders from that contained in the annual report filed on Form 10-K.⁵⁸

Annual Report to Shareholders, 20 VILL. L. REV. 273, 277-91 (1974-75)(discussing other requirements imposed by the SEC).

55. See 17 C.F.R. § 240.14a-3(d) (1988)("When filed as the annual report on Form 10-K, responses to the Items of that form are subject to Section 18 . . ."); see also 17 C.F.R. § 240.14a-11(f) (1988)("Three copies of any portion of the annual report referred to in § 240.14a-3(b) which comments upon or refers to any solicitation subject to this section, or to any participant in any such solicitation . . . shall be filed with the Commission as proxy material . . ."). One commentator, however, described Section 18 as a "toothless tiger." Sommer, *The Annual Report: A Prime Disclosure Document*, 1972 DUKE L.J. 1093, 1102 n.52.

56. 15 U.S.C. § 78l(g) (1986).

57. Prior to 1974, the Commission only required certain financial information in the annual report. See, e.g., Atlantic Research Corp., Findings and Opinion of the Commission, Securities Act Release No. 4,657, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,949 (Dec. 6, 1963) (requiring consolidated financial statements in annual report to shareholders under certain circumstances); Extension of Time for Submitting Comments on Proposed Amendments to Proxy Rules and Information Rules: Adoption of Amendments to Certain Rules, Exchange Act Release No. 8,029, [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,427 (Jan. 24, 1967)(amending Rule 14a-3 to require two years of financial statements in annual report to shareholders).

58. See General Revision of Regulation S-X, Exchange Act Release No. 16,498,

The demise of the unregulated annual report can be traced to two separate Commission rule-making endeavors. In the mid-1970s, the Commission became concerned that while the annual report was widely distributed it was generally unilluminating. To make the document more informative, the Commission substantially increased the amount of disclosure required in the annual report. Nevertheless, the disclosure remained shorter and less oblique than that required in Form 10-K. With the advent of integrated disclosure a few years later, however, the Commission largely conformed the disclosure requirements in the annual report to those of Form 10-K. With the changes, the annual report to shareholders became fully regulated.

Spurred by the findings of a special study, the Commission in 1974 drastically expanded the level of disclosure required in the annual report.⁵⁹ Noting the need for "meaningful information about the company,"⁶⁰ Rule 14a-3 was amended to require inclusion of certified financial statements, a summary of operations, management's analysis, a description of the issuer's business, identification of officers and directors, and market information about the company's stock.⁶¹ Since the same information had to be included in Form 10-K, the 1974 changes encouraged issuers to use

[1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) (P) 82,424, at 82,786-87 (Jan. 15, 1980).

59. Proposed Amendments to Rules 14a-3 and 14c-3 under the Exchange Act to Improve Disclosure in Annual Reports and to Improve Dissemination of Annual Reports; Adoption of Amendments to Item 7 of Schedule 14A under the Exchange Act, Exchange Act Release No. 10,591, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,619 (Jan. 10, 1974)[hereinafter Exchange Act Release No. 10,591]. An advisory committee had recommended the stepped-up requirements. Report of the Industrial Issuers Advisory Committee to the Securities and Exchange Commission, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,149 (Dec. 22, 1972).

60. Exchange Act Release No. 10,591, *supra* note 59, at 83,658.

61. Notice of Adoption of Amendments of Rules 14a-3, 14c-3 and 14c-7 under the Exchange Act to Improve Disclosure in, and the Dissemination of, Annual Reports to Security Holders and to Improve the Dissemination of Annual Reports on Form 10-K or 12-K Filed with the Commission Under the Exchange Act, Exchange Act Release No. 11,079, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,996 (Oct. 31, 1974)[hereinafter Exchange Act Release No. 11,079]("The Commission believes it is in the public interest that all security holders be provided with meaningful information regarding the business management, operations and financial operations position of the issuer and that the annual report to security holders is the most suitable vehicle presently available for providing this information."). See also Exchange Act Release No. 10,591, *supra* note 59, at 83,659 ("The Commission is of the opinion that this information, and other specified information discussed above should be included in all annual reports because such information is important to a security holder's understanding and evaluation of the management for whom he is being asked to vote and of his investments.").

identical disclosure statements in the two documents.⁶²

Following the 1974 changes, issuers confronted the task of producing two separate, heavily regulated reports: the annual report to shareholders and Form 10-K. This increased imposition forced the Commission to again rethink the disclosure process. Based on recommendations of an advisory panel,⁶³ the Commission allowed companies to use Form 10-K to fulfill both the periodic reporting requirements of the Securities Exchange Act of 1934 and the annual report requirement of the proxy rules.⁶⁴

A single document, it was believed, would substantially reduce the disclosure burdens imposed on issuers. The single document approach, however, proved unsuccessful. The notion of sending shareholders a repackaged Form 10-K, with all of its leaden lawyerly language proved unpopular. According to one report, between 1977 and 1979, only five companies used the integrated form.⁶⁵

The Commission, nevertheless, continued to meld the disclosure in the two documents.⁶⁶ Quarterly stock prices became required in 1976,⁶⁷ followed by segment data a year later.⁶⁸ Both documents became subject to Regulation S-K,⁶⁹ the uniform set of instructions for filings under the Securities Act of 1933⁷⁰ and the

62. Nevertheless, the disclosure required in the two documents was not identical. See Exchange Act Release No. 11,079, *supra* note 61, at 84,569 (noting that while the annual report required a brief description of the business, the document did not have to include the "detailed information called for" in Form 10-K).

63. ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, 95TH CONG., 1ST SESS., REPORT TO THE SEC (Comm. Print 1977).

64. Guide 4, Integrated Reports to Shareholders, Exchange Act Release No. 13,639 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,214 (June 17, 1977); see also Amendments to Annual Report Form, Related Forms, Rules, Regulations and Guides; Integration of Securities Acts Disclosure Systems, Exchange Act Release No. 17,114, [Accounting Series Releases 1937-1982] Fed. Sec. L. Rep. (CCH) ¶ 72,301 (Sept. 2, 1980)[hereinafter Exchange Act Release No. 17,114]("[T]he four-part Form 10-K system has been designed to encourage, but not to require, the combination of annual reports and Form 10-K's into one document.").

65. *Folding 10-K's Into Annual Reports*, BUS. WEEK, May 12, 1980, at 38.

66. Exchange Act Release No. 17,114, *supra* note 64.

67. Meyer, *Annual Reports Get an Editor in Washington*, FORTUNE, May 7, 1979, at 212.

68. Adoption of Disclosure Regulation and Amendments of Disclosure Forms and Rules, Exchange Act Release No. 14,306 [1937-82 Accounting Series Releases] Fed. Sec. L. Rep. (CCH) ¶ 72,258 (Dec. 23, 1977). The changes also increased the length of the report. See *An Open-Door Policy for Annual Reports*, BUS. WEEK, May 12, 1975, at 48 (noting that segment data increases reports by an average of four pages).

69. 17 C.F.R. § 1229 (1988).

70. 15 U.S.C. §§ 77a-bbbb (1986).

Securities Exchange Act of 1934.⁷¹ The unabashed goal was uniformity and standardization:

The Commission continues to believe that all security holders should be provided with meaningful information and that the changes in the Form 10-K requirements on which the annual report to security holder requirements were based should also be made in the annual report because of the importance of the disclosure. This results in a uniformity of the minimum disclosure package in the annual report to security holders and in Form 10-K. This uniformity has been achieved by adopting uniform financial statement requirements, by amending Regulation S-X, by adopting new provisions in Regulation S-K and by adopting several changes in Rules 14a-3 and 14c-3. The equivalency of the minimum disclosure package in both documents not only satisfies shareholder and investor needs, it should also avoid duplication by allowing issuers to use the disclosure in the annual report to security holders to satisfy some of the requirements of Form 10-K and, if they choose, when selling securities to the public.⁷²

The Commission tempered the new requirements by permitting issuers to incorporate by reference the disclosure from the annual report into Form 10-K.⁷³

With these changes, the content of the annual report and Form 10-K moved in lock-step.⁷⁴ A change in Regulation S-K affected both documents. These increased reporting requirements failed, however, to reflect the unique goals of the annual report to shareholders.

By casting aside the concept of a single, integrated proxy statement in the 1940s, the Commission set in stone the inefficient process of three separate documents — an annual report to shareholders, a proxy statement, and a Form 10-K. For over forty years, the scheme was not seriously questioned. The system remained intact even after the principal concern of commentators

71. 15 U.S.C. §§ 78a-kk (1986).

72. Exchange Act Release No. 17,114, *supra* note 64, at 62,809.

73. 17 C.F.R. § 249.310 (1988).

74. The Commission made the lock-step approach official in 1980. *See supra* text accompanying note 72. Moreover, the process continues. *See* Report of Management's Responsibilities, Exchange Act Release No. 25,925, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,302 (July 19, 1988) ("The SEC proposes to require that companies include a report of management's responsibilities in Forms 10-K and N-SAR and annual reports to shareholders.").

opposing the "single document" approach ceased to be valid.⁷⁵

The tendency toward increased regulation of the form and substance of the annual report lost sight of the entire purpose of the report in the proxy process. The Commission's original goal had only been to ensure that shareholders had the financial information available in the annual report when executing their proxies. The annual report, however, took on an independent existence in the proxy process. Successive Commission actions resulted in pervasive regulation of the annual report rather than simply prescribing the narrative and financial information essential to the proxy solicitation process. The net effect of this increased regulatory encroachment was to deny management the flexibility to determine the appropriate format for communicating information to its shareholders.

II. THE SUMMARY ANNUAL REPORT

Few would deny the importance of the annual report as a means for communicating with shareholders. As the Commission has noted: The "annual report to security holders is one of the most widely read disclosure documents, and potentially the best suited for communicating information in an informative, readable and understandable form to security holders and potential investors."⁷⁶ Although widely distributed and packed with information, the effectiveness of the annual report has been unclear. For one thing, shareholders by and large do not read it.⁷⁷

This ineffectiveness may in part be explained by regulatory constraints. The proxy rules recite that "the report may be in any

75. See *supra* text accompanying notes 41-44.

76. Exchange Act Release No. 10,591, *supra* note 59, at 83,658; see also Exchange Act Release No. 11,079, *supra* note 61, at 84,568 ("The annual report to security holders has long been recognized as the most effective means of communication between management and security holders."). Annual reports might even impact the market for corporate control. Reports can be drafted with the knowledge that they will be read cover to cover by target companies. In at least one instance, a report portraying a bidder as a congenial place for scientists to work apparently helped encourage high tech targets not to oppose an acquisition attempt. Meyer, *supra* note 67, at 210.

77. See Foy, *Annual Reports Don't Have to be Dull*, 51 HARV. BUS. REV., Jan.-Feb. 1973, at 49, 49 (study concluding that "40% of the stockholders surveyed give the [annual] reports five minutes or less and 15% don't read them at all"); Callvert, *Annual Report - for Stockholders, the Stock Exchanges and the SEC*, FIN. EXECUTIVE, Jan. 1965, at 11, 12 (readership survey showing that 37% of the recipients do not read or even look at the annual report). Even if read, little time is typically spent with the report. See Berg, *Reports Thrive in a Frugal Age*, N.Y. Times, Apr. 13, 1988, at D5, col. 4 (noting that the average investor spends six minutes reading the annual report).

form deemed suitable by management."⁷⁸ In fact, the rules so prescribe the form and content of the annual report that they severely curtail management's flexibility in drafting and formatting the document.⁷⁹ The added disclosure also makes the annual meeting process more expensive. Each extra page of disclosure increases the cost of producing the report and mailing it to shareholders.⁸⁰ The benefits of the required disclosure often do not outweigh the added costs and the loss of drafting flexibility.⁸¹

No-action letters during the 1970s indicate the degree to which practitioners felt constrained in drafting and formatting annual reports. Letters sought advice on the print size of the notes to the financial statements,⁸² the ability to include advertisements,⁸³

78. 17 C.F.R. § 240.14a-3(b)(11) (1988). The Commission has emphasized the non-technical nature of the annual report. Exchange Act Release No. 11,079, *supra* note 61, at 84,568 ("Such reports are readable because they generally avoid legalistic and technical terminology and present information in an understandable, and often innovative, form."). The detailed disclosure requirements of Rule 14a-3(b) seem inconsistent with the often stated goal of simplicity and flexibility. Not only must an annual report include substantial information, but the proxy rules to some degree regulate the type of paper used and the size of the print. 17 C.F.R. § 240.14a-3(b)(2) (1988); *see also* Wall Street Growth Fund, Inc., SEC No-Action Letter (Nov. 13, 1972)(LEXIS, Fedsec library, Noact file)(noting that semi-annual reports for investment companies must be printed in 10 point type and further specifying where certain items of information are to be located within the report). *But see* 17 C.F.R. § 240.14a-3(b)(12) (1988)("[T]he annual report to security holders of [investment companies registered under the Investment Company Act of 1940] may be in any form deemed suitable by management."). Finally, the rules "encourage" certain methods of presenting information. *See* 17 C.F.R. § 240.14a-3(b)(11) note (1988) ("Registrants are encouraged to utilize tables, schedules, charts, and graphic illustrations of present financial information in an understandable manner."). In view of the foregoing, management has at best modest flexibility in drafting annual reports.

79. The extensive regulation of the annual report to shareholders reached a zenith of sorts in the late 1970's when the Commission brought the document into the integrated disclosure process. *See supra* notes 59-74 and accompanying text. Prior to this time, companies retained a significant amount of flexibility over the contents of the annual report. Indeed, studies indicated that the contents of annual reports and Form 10-Ks, including the financial statements, diverged considerably. *See* Singhvi, *Disclosure to Whom?*, 41 J. Bus. 347, 351 (1968).

80. *See infra* notes 86, 96, 113 and accompanying text.

81. In addressing this problem, the Commission has observed that "increasing the amount of required disclosure in annual security holder reports involves a risk that readability may be impaired." Exchange Act Release No. 17,114, *supra* note 64, at 62,809. To prevent adverse consequences, the Commission promised "to monitor the situation." *Id.* More recently, the Commission questioned the effectiveness of some aspects of the existing disclosure regime. *See* Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6,711, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,118, at 88,627 (Apr. 20, 1987).

82. *See* Wall Street Growth Fund, Inc., *supra* note 78 (annual report of an investment company).

83. Berger Nechamkin & Associates, Inc., SEC No-Action Letter (July 9,

and whether financial statements could be placed in a pocket part.⁸⁴ Most of the letters raised issues, the resolution of which seemed clear under the rules. The letters reflected an attitude that annual reports were fully regulated, with variations from the norm requiring approval from the Commission staff.

The dearth of interest in reports generated some unusual, and often expensive, efforts to grab the attention of shareholders. Glossy reports came into vogue in the 1950s.⁸⁵ In 1964, Litton Industries commissioned Andrew Wyeth to create a painting for its report cover.⁸⁶ More recently, reports have been scented with the smell of spices,⁸⁷ included pop-ups of corporate headquarters,⁸⁸ software,⁸⁹ and individual pictures of more than 3,000 employees,⁹⁰ in addition to a host of novel cover designs.⁹¹

The problems associated with annual reports did not go unnoticed in the private sector. In 1983, the firm of Deloitte, Haskins & Sells prepared a study for the Financial Executives Research Foundation on the use of abbreviated annual reports.⁹² As the study explained:

1979)(LEXIS, Fedsec library, Noact file); *see also* Time Inc., SEC No-Action Letter (Apr. 4, 1977)(LEXIS, Fedsec library, Noact file)(permitting corporations to publish quarterly reports in magazines). Gulf & Western reprinted its 1978 Annual Report in Time Magazine at a cost of \$5 million. Meyer, *supra* note 67, at 210.

84. Fletcher Mayo Associates, SEC No-Action Letter, [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,394 (Oct. 1, 1975); *see also* Crossman-Thaddeaus Corp., SEC No-Action Letter (Nov. 24, 1976)(LEXIS, Fedsec library, Noact file)(taking the position that annual report can include trading information not required by Rule 14a-3).

85. Meyer, *supra* note 67, at 212.

86. *Id.*

87. *See* Byrne, *This Year's Annual Reports: Show Business as Usual*, BUS. WEEK, Apr. 13, 1987, at 42 (noting that McCormick & Co., a spice maker, has used scents in its annual report since 1977).

88. *Id.* (noting that Genetech's 1987 Annual Report contained a pop-up of the company's headquarters).

89. *See The Hyper Card Supplement*, PERS. COMPUTING, April 1988, at 40.

90. Byrne, *Annual Reports: The Good, the Bad, and the Ridiculous*, BUS. WEEK, Apr. 7, 1986, at 40 (noting that Herman Miller, Inc.'s 1985 annual report contained one and one-half inch pictures of all 3,265 employees).

91. *See* Berton, *The Gallery: Annual Reports as Art*, Wall St. J., Aug. 18, 1988, at 20, col. 1.

The reports of Domino's Pizza Inc. for 1982, 1984 and 1985 used round financial statements shaped like a pizza, an actual domino game in a wooden box and a newsboy's canvas bag. Musical instrument maker Norlin Corp.'s 1974 annual report is a record jacket containing an LP album 'Music in America.' And Red Owl Stores Inc.'s 1970 report resembles a brown paper shopping bag with an attached register receipt for \$30.31.

Id.

92. 1 S. GOLUB & J. KUEPPERS, *supra* note 22.

Financial statements, footnotes and supplementary disclosures, in becoming more voluminous, have become too complex and perhaps too intimidating for the average reader. And, to make all statements technically correct, footnotes and other disclosures are often written in a style and a vocabulary that only accountants and attorneys can readily understand.

Surveys have shown that five to fifteen minutes is as much time as the average reader spends on an annual report. This suggests that the average reader can digest only a fraction of the information in these lengthy documents and may rely mostly on the highlighted information. So, we have information overload, and it has denied the average reader of annual reports the very benefits that the new disclosure requirements are intended to offer.⁹³

As part of the study, nineteen companies prepared both conventional annual reports and summary reports.⁹⁴ After examining the documents, the Deloitte study ventured a number of conclusions. First, summary annual reports were substantially shorter than conventional reports, with the number of pages of financial disclosure decreased from an average of twenty-four to eleven (a fifty-four percent reduction).⁹⁵ The page reduction was generated primarily through the use of condensed information on balance sheets, eliminating or shortening footnotes, reducing the segment data, and eliminating the report of the independent accountants. The summary annual report also tended to be easier to read. "The summary reports were believed to be more readable than the conventional annual reports from which they were derived. They were shorter. More importantly, the companies focused on effective communication of information in laymen's language, without the constraints imposed by all the technical disclosures required under the present system."⁹⁶

The Deloitte study, however, contemplated the use of a sum-

93. *Id.* at 1-2.

94. *Id.* at 1.

95. *Id.* at 5.

96. *Id.* Others sought to reduce duplication by combining into a single document the annual report to shareholders and the Form 10-K. The SEC approved this procedure. Teradyne, Inc., SEC No-Action Letter (Dec. 11, 1973)(LEXIS, Fedsec library, Noact file). Nevertheless, this approach proved impractical for most issuers. By including all of the information required by Rule 14a-3(b) and Rule 13a-1 in a single document, shareholders received an even longer annual report. In addition to likely increases in postage and production costs, a longer annual report was not necessarily a more effective document. *See supra* notes 77-78.

mary annual report in place of the existing annual report. The study, therefore, proposed reduced disclosure to shareholders, a proposition unlikely to persuade an agency that had always viewed its principal goal as increasing the amount of available information. Predictably, the Commission indicated unhappiness with the summary annual report notion and nothing came of the study.⁹⁷

The issue lay dormant for several years. In 1986, General Motors Corporation (GM) reopened the matter and again advanced the concept of a summary annual report. General Motors had incentive. Rationalizing the disclosure process would reduce the cost of the annual meeting process. With a substantial number of record owners, GM had to print large quantities of annual reports for distribution to shareholders and investors. Every page of glossy paper eliminated from the report reduced costs.⁹⁸

Perhaps aware of the Commission's prior opposition to the summary annual report, GM did not propose the abbreviated report as a substitute for, but as an addition to, the disclosure required in Rule 14a-3. General Motors suggested that the proxy statement include as an appendix all information required in Part II of Form 10-K, including audited financial statements and management's discussion and analysis.⁹⁹ Shareholders electing directors would, therefore, receive all necessary information in a single document.

With all the necessary information in the proxy statement, GM posited that the annual report to shareholders "could be dropped entirely."¹⁰⁰ Nonetheless, the company acknowledged

97. See Business Combination Transactions — Adoption of Registration Form, Exchange Act Release No. 21,982, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,418, (Apr. 23, 1985) ("The Commission has not sanctioned in this proceeding any revision of the basic information package, such as summary annual reports to security holders.").

98. The average 1987 annual report costs \$3.00, up from \$2.85 the year before. A five billion dollar industry, annual report costs for publicly traded companies average \$463,000. Berg, *supra* note 77, at D5, col. 1. Although dated, one article indicated that, in 1963, AT&T distributed 3.2 million copies of its annual report. Callvert, *supra* note 77, at 12. According to the article, AT&T needed 2.28 million reports for record owners; 150,000 for street name accounts; 170,000 for "investment dealers, banks, trusts and brokers"; 510,000 for distribution during the year to investors; and 90,000 for use by Bell subsidiaries. *Id.* AT&T's needs increased to four million by 1985. Byrne, *supra* note 90, at 40. Obviously, savings on postage and printing resulting from a thinner document can be significant when such large quantities are involved. See *infra* text accompanying note 112.

99. General Motors Corp., *supra* note 11, at 77,311.

100. General Motors Corp., *supra* note 11, at 78,401. The Commission staff had previously taken the position that financial statements did not have to be physically attached to the annual report. See Fletcher/Mayo/Associates, Inc., SEC No-Action Letter,

that the report had "value as a general communication medium."¹⁰¹ The report would be sent to shareholders, but would contain only financial highlights, a basic financial statement, other key financial data deemed appropriate, an accountant's report, and a narrative discussion of the financial information included.¹⁰² Neither the Form 10-K nor the proxy statement would incorporate by reference any portion of the annual report to shareholders. Since the proxy statement was to contain all of the required information, including financial statements, GM was seeking to use the same basic format proposed by the Commission in 1942.¹⁰³

The suggested format met with staff approval. General Motors' "proposal provides a sound means to permit the free writing desired in the company's glossy report while assuring that GM shareholders receive, on a timely basis, all of the financial information mandated by the Commission's proxy rules."¹⁰⁴ Approval, however, came at a price. While not imposing conditions on the use of summary reports, the staff's letter did reiterate the undertakings agreed to by GM, including:

1. The release of the full audited financial statements with the earnings press release, and extensive circulation of the release to the market;
2. The filing of the Form 10-K report with the Commission at or prior to the release of the glossy report;
3. The proposed auditors' report on the financial information with the financial data in the glossy report;
4. The inclusion of the full information required by Rule 14a-3(b) in both the Form 10-K and an appendix to the annual election of directors proxy statement; and . . .
5. The undertaking in the glossy report, as well as the proxy statement, to provide the Form 10-K upon request.¹⁰⁵

The staff also commented specifically on the reduced level of financial disclosure in the summary report.

The extent to which General Motors includes summary fi-

[1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,394, at 86,051 (Oct. 1, 1975)(agreeing not to recommend enforcement action if financial statements "appear in a 'pocket part' inserted inside the back cover of the [annual] report"). The no-action letter did not address whether the financial statements could be included in the proxy statements.

101. General Motors Corp., *supra* note 11, at 77,311.

102. *Id.*

103. See *supra* text accompanying note 40.

104. General Motors Corp., *supra* note 11, at 77,311.

105. *Id.*

nancial information in its glossy report, as with any corporate communication not prescribed by the Commission's rules, is a matter for the company's determination. As with all corporate communications that can reasonably be expected to affect the market for the corporation's securities, the glossy report including the summary financial information is subject to the prescriptions of [the antifraud provisions].¹⁰⁶

Four months later, the staff issued a second letter on the same subject. McKesson Corporation sought the staff's views on a format similar to the one proposed by GM. Unlike GM, however, McKesson did not propose to include in the summary annual report an undertaking to provide a copy of the Form 10-K upon request.¹⁰⁷ The staff expressed no comment on the change.¹⁰⁸ Indeed, as a wholly unregulated document, the summary annual report is arguably not subject to any affirmative disclosure requirements, including the minimal and innocuous requirement that a Form 10-K be provided on request. Otherwise, the McKesson letter added no new insight on the staff's treatment of summary annual reports. With the McKesson letter a door closed. Thereafter, the staff declined to review further letters on the subject.¹⁰⁹

General Motors received the letter late in the proxy season and did not distribute a summary annual report. McKesson did distribute an abbreviated report. The report consisted of twenty-four pages,¹¹⁰ compared with forty pages the previous year.¹¹¹ The document strongly resembled a conventional annual report in format and style but without certain data such as notes to the financial statements. According to published accounts, the use of the summary annual report saved the company approximately \$110,000 in production and postage costs.¹¹² Despite the unique nature of the report and the sensitive issues created by its use,

106. *Id.*

107. McKesson Corp., *supra* note 11.

108. *Id.*

109. Business Wire, June 1, 1987. Although no longer issuing additional letters, the staff has apparently continued to refine its position. The Wall Street Journal reported that the staff's position no longer required companies to release complete financial statements to the public before distributing summary annual reports. Wall St. J., Sept. 18, 1987, at 1, col. 1. Advance distribution of the report, however, may raise concerns under the antifraud provisions. See *infra* notes 163-246 and accompanying text.

110. MCKESSON CORP., 1987 ANNUAL REPORT (1987).

111. MCKESSON CORP., 1986 ANNUAL REPORT (1986).

112. Wax, *Condensed Annual Report Planned*, Philadelphia Inquirer, June 6, 1987, at C13, col. 1.

McKesson unnecessarily complicated the matter by failing to include in the proxy statement all of the information required by Rule 14b-3(b).¹¹³

One year later, at least seven companies used the summary format.¹¹⁴ Notwithstanding the objections of some analysts,¹¹⁵ the abbreviated report proved popular with shareholders.¹¹⁶ Moreover, the documents continued to be thinner, thus generating apprecia-

113. See *infra* notes 153-57, and accompanying text.

114. Companies using a summary annual report during the 1987 proxy season included: American Fructose Corp., AMERICAN FRUCTOSE CORP., SUMMARY ANNUAL REPORT (1987); American Maize-Products Co., AMERICAN MAIZE-PRODUCTS CO., SUMMARY ANNUAL REPORT (1987); Branch Corp., BRANCH CORP., 1987 ANNUAL REVIEW (1987); Figgie Int'l Co., FIGGIE INT'L., 1987 SUMMARY REPORT (1987); Kroger Co., KROGER CO., 1987 ANNUAL REPORT (1987); McKesson Corp., MCKESSON CORP., MCKESSON TODAY (June 1988) (annual report issue); SPX Corp., SPX CORP., REPORT TO SHAREHOLDERS (1987). One commentator put the number of summary reports in 1988 at 13. See Cato, *When Preparing Annual Reports, Less Is Definitely Not More*, Wall St. J., Aug. 22, 1988, at 12, col. 3.

115. The Institute of Chartered Financial Analysts has intimated concern for the summary format.

The Institute of Chartered Financial Analysts has not taken a position, nor has it published any views, on the summary annual report format. However, our sister organization, the Financial Analysts Federation, has discussed the matter internally at appropriate committee levels and has shared its unofficial views when asked. The FAF has not yet adopted an official statement on this subject.

As you are well aware, issuers argue that annual reports have become too loaded with detail to be readable, that the typical individual investor is confused by, and does not want, all the information currently presented in annual reports, and that professional and sophisticated investors can obtain the information they desire from sources other than the annual report, primarily the SEC filings. In this regard, the FAF is concerned about investors' need for full disclosure at one time under one cover, the lack of immediate accessibility of 10-K and proxy statements, and problems with accessibility in that if full statements are in the proxy, but with sections incorporated by reference to the 10-K. In short, our concern with summary annual reports is one of timely and full disclosure in easily accessible format.

Letter from Alfred C. Morley, President, Institute of Chartered Financial Analysts, to J. Robert Brown, Jr. (Aug. 30, 1988). See also *infra* note 128. The summary report has also engendered virulent opposition from Sid Cato, the publisher of a newsletter on annual reports. Galant, *The Wacky World of Sid Cato*, INVESTOR RELATIONS, July 1988, at 2 (Cato "detests summary annual reports . . . contending they do nothing but cheat shareholders out of information."). Given that the full information is available in the annual report on Form 10-K and the expanded proxy, the objection reduces to the complaint that these documents are not always available simultaneously with the summary report and they require the extra step of writing to the company for a copy. Fisher, *Shareholders Gave Rave Review to Kroger's Summary Report*, Cincinnati Bus. Courier, June 6, 1988, at 2, col. 3.

116. Fisher, *supra* note 115. Receiving a positive reception, McKesson again used the summary report format for the 1987 fiscal year. *McKesson Announces Financial Results*, Business Wire, May 25, 1988.

ble cost savings.¹¹⁷

III. ANALYSIS

Viewed in context with the historical purpose of the Commission's regulation of annual reports, the GM/McKesson letters are unremarkable. The lengthened proxy statement and unregulated annual report differed little from what the Commission had proposed in 1942. Moreover, the GM/McKesson format was eminently consistent with the underlying purpose behind Commission regulation of annual reports. The Commission drew the report into the regulatory scheme only to ensure that shareholders had access to the type of financial and narrative information necessary for the informed exercise of the corporate franchise, not out of concern over the contents of annual reports *per se*. The GM proposal ensured the availability of the information while returning formatting flexibility to management.

Arguably, GM did not need to obtain the Commission's concurrence with the proposed format. The appendix to the proxy statement met all of the disclosure requirements of Rule 14a-3(b). Attachment to the proxy statement represented the only significant difference between the GM appendix and a conventional annual report — a distinction without a difference. Nothing in Rule 14a-3(b) prohibited a company from attaching the annual report to the proxy statement. In fact, the rule suggests quite the opposite. By requiring the report to precede or accompany the proxy statement,¹¹⁸ Commission rules seem to promote attachment of the report to the proxy. General Motors probably should have labeled the appendix as the "annual report" and dispensed entirely with the no-action request.¹¹⁹

117. Kroger Co., for example, issued a 16 page Summary Report, down from 32 the year before. Fisher, *supra* note 115. See also *supra* notes 98, 112, and *infra* note 130 and accompanying text.

118. See *supra* note 4-9 and accompanying text.

119. This statement reflects the views of the authors. Because one of the authors is currently employed at the Securities & Exchange Commission, mandatory review of the article was required by Ethics Counsel at the agency. See 17 C.F.R. § 200.735 (1988). As part of the review process, Ethics Counsel required language changes in five places in the text and three in the footnotes to make clear that the views espoused in the article were those of the authors and not necessarily those of the Commission. Normally, this entailed the addition of the phrase "in the authors' belief" at the beginning of each offending sentence. While at least one author believes that the disclaimer in the first footnote sufficiently alleviates any concern in this area, we have, out of expediency, nonetheless agreed to the requested language changes. Rather than destroy the flow of the text with the cumbersome

Since the requirements of Rule 14a-3 were satisfied by the appendix, any abbreviated annual report would be an additional, voluntary communication, wholly unregulated by the Commission. Moreover, characterizing the appendix as the annual report would yield an affirmative advantage,¹²⁰ because the financial statements could be incorporated by reference into the report on Form 10-K.¹²¹ Because GM and McKesson did not treat the appendix as the annual report, they agreed to include complete financial information in the proxy statement and the Form 10-K rather than incorporate it by reference. The result was a certain amount of unnecessary duplication.

Nevertheless, by endorsing the GM/McKesson proposals, the staff has accelerated the demise of the heavily regulated, unthinking, all-purpose, and often incomprehensible annual report. The staff response also obviated a number of potential legal concerns. For example, Section 14(b)¹²² gives the Commission rulemaking authority to regulate the distribution of proxies, consents, and authorizations by brokers and banks. The shareholder communication rules adopted under this section require brokers and banks to forward proxy materials to beneficial owners.¹²³ To the extent that annual reports do not constitute proxy materials, the Commission may not have the authority to require distribution by brokers or banks. In apparent recognition of the limited scope of Section 14(b), the Commission does not require brokers and banks to distribute information statements to beneficial owners.¹²⁴

Furthermore, this interpretation eliminates the legitimate

and repetitive phrase, however, the additional language was inserted in a footnote to each sentence.

120. This statement reflects the views of the authors. *See supra* note 119.

121. *See* Instruction G to Form 10-K, 45 Fed. Reg. 63,638 (1980). In providing interpretative advice, the staff has agreed with this position.

122. Securities Exchange Act of 1934 § 14(b) (current version at 15 U.S.C. § 78n(b) (1986)).

123. 17 C.F.R. §§ 240.14b-1 & 240.14b-2 (1988). *See also* Brown, *Shareholder Communications and the Securities & Exchange Commission: An Exercise in Regulatory Utility or Futility?*, 13 J. CORP. L. 684 (1988)(discussing rules 14b-1 and 14b-2).

124. Under Rule 14c-7(a)(3), issuers must provide brokers and banks with copies of information statements for distribution to beneficial owners. 17 C.F.R. § 240.14c-7(a)(3) (1987). Rule 14b-1, however, only requires brokers to forward any "proxy, other proxy soliciting material, and/or annual reports to security holders." 17 C.F.R. § 240.14b-1(b) (1988). Information statements are not expressly mentioned. At least one commentator has suggested that the Commission lacks the authority to force brokers and banks to distribute information statements. Phillips & Shipman, *An Analysis of the Securities Act Amendments of 1964*, 1964 DUKE L.J. 706, 734.

concern of some companies about untimely delivery of annual reports. To reduce costs, issuers often split-mail, sending the proxy statement by first class and the annual report by third.¹²⁵ Under Rule 14a-3, however, the annual report must arrive concurrently with, or before, the proxy statement.¹²⁶ Given the vagaries of the postal system, mailing the annual report by third class mail raises the specter of untimely receipt by shareholders. Moreover, the Commission has resolutely refused to provide any safe harbor or guidance on how to ensure timely receipt.¹²⁷ Allowing companies to attach the relevant information to the proxy statement resolves these timing problems.

In addition to alleviating certain legal uncertainties, the most obvious advantage of the new regulatory regime is the heightened flexibility accorded management in drafting annual reports. The reasoning of the GM/McKesson letters provide issuers with three broad choices in drafting annual reports: (1) distribution of a standard, glossy annual report that conforms with all of the requirements of Rule 14a-3(b); (2) distribution of a summary annual report; or, (3) foregoing completely the distribution of an annual report of any kind.

A. Standard Annual Report

A standard annual report containing all of the information required by Rule 14a-3(b) arguably still offers advantages. Companies may opt for the report under the theory that shareholders are better off with an overabundance of information. Indeed, some groups have objected to summarized financial information in annual reports.¹²⁸ A standard annual report also provides a degree of

125. Pease, *Preparing for the Annual Meeting: The Pressures and Problems*, 1 DEL. J. CORP. L. 302, 316 (1976)(of 733 companies surveyed, 328 sent annual reports by third or fourth class bulk mail).

126. *Ash v. GAF Corp.*, 723 F.2d 1090, 1091 (3d Cir. 1938). *See also* Exchange Act Release No. 7,078, *supra* note 54 (noting that it would violate the proxy rules to send proxy statements by first class mail while simultaneously sending annual reports by fourth class mail).

127. Facilitating Shareholder Communications, Exchange Act Release No. 22,533, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,930, at 87,875 (Oct. 15, 1985).

128. *See supra* note 115. *See also* HILL & KNOWLTON, INC., INVESTMENT ANALYSTS' ATTITUDES TOWARD SUMMARY ANNUAL REPORTS, A SURVEY 7 (May 1987)("Sixteen of the 25 analysts surveyed — 64 percent — were against companies' publishing a summary annual report."). The study, however, should perhaps be viewed with skepticism. First, only a small number of analysts were questioned. Second, the study came out before

comfort. The content requirements of Rule 14a-3(b) have become familiar and the format of the annual report standard. Adhering fully to the disclosure requirements of Rule 14a-3(b) enables those drafting the report to avoid hard decisions about what information should be included or excluded from the document.

The standard annual report also offers a significant practical advantage over the summary report. With the contents largely mandated, use of the conventional report reduces the likelihood that a misleading document will be created and minimizes the risk that the report will be subject to the antifraud provision contained in the proxy rules.¹²⁹ Thus, a full-blown standard report may alleviate some of the risk of a Commission enforcement action.

Of course, distributing a standard annual report does not address the problems of unnecessary length and incomprehensibility that the summary report seeks to correct. Accordingly, companies which continue to issue standard annual reports may nevertheless consider producing a supplemental summary report that can be distributed as a promotional piece throughout the year.

B. Summary Report

Using a summary annual report offers immediate advantages. Summary reports should generate cost savings.¹³⁰ Frequently, annual reports are printed on heavy, glossy white paper. A shorter report reduces both production and postage costs. An issuer could simply reduce the size of the document, perhaps by eliminating footnotes or segment reporting.¹³¹

McKesson actually distributed the first summary annual report. Finally, other commentators have adopted the contrary viewpoint. See *Enhanced Proxy Statement Contains Audited Financials*, SORG SAYS, Aug. 1987, at 1 (noting that analysts who follow McKesson have registered a "highly positive" response to the company's summary annual report).

129. See *infra* notes 193-236 and accompanying text.

130. See *supra* note 98. The monetary savings must be balanced against several potential disadvantages. One commentator identifies these disadvantages as: (1) the lack of a 14a-3 waiver; (2) the opposition of security analysts to the use of summary annual reports; (3) the opportunity presented by the report format to hide bad news in the proxy statement appendix; (4) the lack of SEC guidelines for the reports; (5) Generally accepted accounting principles (GAAP) requirements limiting the auditor's certification to the condensed financial statements actually contained within the summary report; (6) the need, in most instances, to use a communications professional in the preparation of the summary report; and (7) the lack of available feedback concerning shareholder reaction to summary annual reports. Dubin, *Consideration of Use of a Summary (Non-Rule 14a-3) Annual Report*, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 457, 464-65 (1988).

131. Ordinarily, issuers must disclose financial data about significant industry segments. Interpretations, Guidelines, and Administrative Determinations, Exchange Act Re-

Focusing on the possibility of cost savings, however, represents too narrow a view of the advantages of a summary report. Importantly, a summary report may result in more effective disclosure. As currently incarnated, the annual report suffers from the need to serve too many masters. All shareholders receive the same annual report, irrespective of their level of interest or sophistication.¹³² The result is a schizophrenic document, with an annual report containing both a fluffy narrative that appeals to those shareholders with limited interest in the company and a densely packed, tightly drafted financial discussion that appeals to analysts, institutional shareholders, and other sophisticated investors.

With their newly found flexibility, management can draft a summary annual report specifically designed for particular audiences.¹³³ For example, a relatively simple report might be drafted for shareholders with small holdings. Those with holdings below a predetermined threshold arguably have a reduced need for comprehensive information about the issuer. With fewer pages than conventional annual reports and reduced financial disclosure, the

lease No. 14,523, [1937-1982 Accounting Series Releases] Fed. Sec. L. Rep. (CCH) ¶ 72,266 (Mar. 3, 1978). An industry segment is significant if it accounts for 10% or more of the total revenues, profits or losses, or assets of the entire business. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 14, at ¶ 15 (1988). An issuer with a large number of industry segments may simply decide to report the information on a consolidated basis, without separate segment disclosure. Eliminating footnotes represents another possibility. Of course, wholesale elimination of footnotes may not always be appropriate. See Gubernick, *See Footnote*, FORBES, Sept. 24, 1984, at 160 (discussing the importance of information on bank standby letters of credit contained in footnotes to annual reports).

132. Interestingly, the Commission has acknowledged the inability of many shareholders to understand and analyze the complex information normally found in the Form 10-K. See Exchange Act Release No. 10,591, *supra* note 59, at 83,658 ("Form 10-K reports, however, are of little direct value to the average security holder who do [sic] not have such access and may not have the necessary background and experience to analyze the contents."). Ironically, the Commission's solution has been to incorporate more information from the Form 10-K into the annual report to shareholders. See Exchange Act Release No. 11,079, *supra* note 61, at 84,568. ("Accordingly, the Commission has amended Rules 14a-3 and 14c-3 to require that an annual report to security holders contain a minimum quantum of meaningful business and financial information, most of which is already required in the annual report on Form 10-K . . ."). A more appropriate response would have been to devise separate disclosure rules for the annual report designed to meet the needs of the report's audience. The summary annual report affords the opportunity for a more focused disclosure.

133. The Commission has noted the different informational needs of various categories of shareholders. See Exchange Act Release No. 17,114, *supra* note 64, at 62,808. ("The constituencies which have been the most frequent users of Form 10-K information, are institutional investors, professional security analysts and sophisticated individual investors.").

simplified version could still be printed on expensive paper and include an attractive color scheme. A second report with more detail could be drafted to address the informational needs of sophisticated investors and analysts. The report could be printed on less expensive paper without all of the public relations flourishes included in the version sent to ordinary shareholders. Of course, companies could provide analysts with all the needed information by simply giving them copies of the annual report on Form 10-K and the proxy statement.¹³⁴

The size of their holdings does not represent the only appropriate means of classifying shareholders. For some companies, geography may be an appropriate classification. Sizable numbers of shareholders may reside in specific counties, states, or regions. A summary annual report could be drafted in a way that emphasizes a company's facilities or activities in the relevant geographic area. Particularly for companies with a history of community involvement, the summary annual report would enable that involvement to be related to those most directly affected.

Any group of sufficient size may be ripe for a customized summary annual report. Employees, first time investors, long time investors, foreign shareholders, particular age groups, all represent possible target groups. In each instance, the company could distribute a report that highlights issues or facilities of interest to the particular shareholder group.

Different versions of the report would to some degree neutralize the concerns voiced by critics who view the summary report as a guise to reduce disclosure and obscure important developments.¹³⁵ Not a new concern,¹³⁶ the need of analysts for complete information need not overshadow the likewise legitimate informa-

134. The Commission has noted the importance of the Form 10-K to analysts. See Exchange Act Release No. 10,591, *supra* note 59, at 83,658. ("[T]he detailed disclosure required in annual reports on Form 10-K is of significant value to securities analysts.").

135. See *supra* notes 115, 128 and accompanying text.

136. See *Annual Reports: More Candor*, N.Y. Times, Apr. 30, 1983, at 29, col. 3 ("When it comes to delivering bad news, annual reports are usually a tribute to the art of understatement."); Byrne, *Curious About the Crash? Don't Read Your Annual Report*, BUS. WEEK, Apr. 11, 1988, at 66.

Proctor & Gamble Co. may get the prize for burying bad news in a bed of fluff. Its annual, including a 24 page 150th anniversary booklet, dispenses with the summary of financial results that leads off most annuals. Instead, readers must wade through six paragraphs of good-looking numbers before finding the bomb: an \$805 million restructuring charge that cut net income by 54%.

Id.

tional need of less sophisticated shareholders for an understandable report. Indeed, less complex summary annual reports have been well received by shareholders.¹³⁷ By sending a complete version to analysts and sophisticated shareholders and a more readable report to other shareholders, each group will have their particular needs met.

A summary annual report may also be an ideal communication medium in certain special circumstances. The accounting treatment of a merger is one area where a summary annual report can be both more effective and more informative than a conventional annual report. Some acquisitions must be treated as a "pooling" of interests, rather than a purchase. Generally accepted accounting principles (GAAP), however, dictate that the pooling cannot be given effect until after consummation of the merger.¹³⁸ If consummated after the close of the fiscal year, the financial statements in the annual report to shareholders cannot give effect to the pooling but must instead contain the acquiring company's financial statements.

As a practical matter, historical earnings of the acquiring company may be of little value to shareholders and investors, and even somewhat misleading. The acquisition may have been approved long before the end of the fiscal year, with the closing delayed for regulatory or tax reasons. In the period preceding the closing, the companies will often have been acting in concert, with the process of combining operations already underway. Moreover, if the transaction closes shortly after the first of the year, the two companies will have been operating on a combined basis for several months by the time shareholders receive the report. Under these circumstances, shareholders would be better served by combined financial statements of the acquiring and acquired company.

Under current accounting practices, an acquiring company may only show the effect of the pooling in their financial statements either through footnotes or the inclusion of both historical and pooled financial statements.¹³⁹ Disclosure in footnotes often obscures rather than elucidates the financial picture. Moreover, including both historical and combined financial statements is not a particularly appealing solution. In addition to the attendant con-

137. See *supra* note 116 and accompanying text.

138. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD OP. NO. 16, at 61 (1988).

139. See, e.g., PNC FINANCIAL CORP., 1987 ANNUAL REPORT 26 (1988).

fusion associated with two sets of financial statements, the additional disclosure will increase the length and cost of the report.

The summary annual report format presents a neat solution.¹⁴⁰ Financial statements of the acquiring company could be included in the appendix to the proxy statement and the Form 10-K. Once this is done, management has almost unlimited discretion in determining the contents of the summary report. The summary annual report could, therefore, include the companies' combined financial statements, while leaving out the historical statements. This format would allow issuers to provide the marketplace with increased financial information in a manner more useful to shareholders.¹⁴¹

An example of the utility of this format, in practice, can be gleaned from a comparison of the 1987 annual reports issued by Meridian Bancorp, Inc.¹⁴² and PNC Financial Corp.¹⁴³ The holding companies of both banks executed agreements to acquire other financial institutions in 1987. Both elected to account for the acquisition as a pooling of interests rather than a purchase and both consummated the transaction in early 1988.¹⁴⁴ Because of the closing dates, the annual reports had to include historical financial statements.

In conformity with accounting literature, PNC dutifully issued an annual report containing both combined and historical financial statements. Financial disclosure consumed sixty-eight pages of the ninety-six page behemoth, or more than seventy per-

140. This statement reflects the views of the authors. See *supra* note 119.

141. Indeed, financial statements utilized in summary reports need not conform to Regulation S-X. See Regulation S-X, 17 C.F.R. § 210 (1988). In years past the Commission did not regulate the contents of annual reports. Thus, issuers sometimes used different financial statements in the annual report and the Form 10-K. See *In re Atlantic Research Corp.*, Exchange Act Release No. 4,657, [1963 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,949 (Dec. 6, 1963) (permitting use of financial statements in Form 10-K which differ from those used in the annual report). With the summary annual report no longer regulated, the financial statements need not duplicate those appearing in the Form 10-K or appendix to the proxy statement. Of course, the financial statements in the summary annual report may not be misleading. See *infra* notes 163-246 and accompanying text.

142. MERIDIAN BANCORP INC., MERIDAN 1987 ANNUAL REPORT (1988).

143. PNC FINANCIAL CORP., 1987 ANNUAL REPORT (1988).

144. Meridian entered into an agreement to acquire Delaware Trust Company in May 1987. MERIDIAN BANCORP INC., *supra* note 142, at 2. The transaction closed on January 1, 1988. *Id.* PNC also entered into an agreement to acquire Central Bancorporation, Inc. in 1987. PNC FINANCIAL CORP., *supra* note 143, at 24. The transaction closed on February 29, 1988. *Id.* at 25.

cent of the document's contents.¹⁴⁵ Of the sixty-eight pages, seventeen, or twenty-five percent, were devoted to the historical financial statements.¹⁴⁶ Removal of the historical statements would have significantly trimmed the length, as well as the cost, of the document.

In contrast, Meridian eliminated the historical earnings and included only pooled financial statements.¹⁴⁷ Meridian distributed a substantially thinner annual report. The fifty-four page annual report contained forty-two pages of financial disclosure.¹⁴⁸ Not

145. See *id.* at 25-92.

146. See *id.*

147. Meridian did not actually use a summary annual report. Instead, the holding company obtained no-action relief. In a letter dated October 28, 1987, the staff agreed to permit Meridian to use combined financial statements in the annual report, but imposed the following conditions:

1. The annual report on Form 10-K which will be filed prior to the distribution of the annual report to shareholders will include separate historical financial statements, separate MD & A and separate Guide 3 information for Meridian and DTC.
2. The annual report to shareholders which will include combined financial statements, MD & A and Guide 3 information will be incorporated by reference in the Form 10-K.
3. The auditor's report in the annual report to shareholders will contain a middle paragraph which will describe the combined nature of the basis of presentation. Prominent disclosure will also be made elsewhere in the annual report indicating the basis of the presentation and informing shareholders of the existence and availability of the separate audited historical Meridian and DTC financial statements included in the previously filed Form 10-K. Capsule financial information, as indicated in your letter, for Meridian and DTC will also be included in the annual report to shareholders.
4. The 1987 annual report to shareholders will not be circulated prior to consummation.
5. If the merger is not consummated by March 31, 1988, then the proposed reporting in the annual report to shareholders would not be appropriate.

Letter from Joseph S. Aleknavage, Assistant Chief Accountant, Division of Corporation Finance, Securities & Exchange Commission to J. Robert Brown (Oct. 28, 1987). Had no-action relief not been forthcoming, a summary annual report would have been an appropriate vehicle for achieving the same result.

148. MERIDIAN BANCORP INC., *supra* note 142, at 12-51. Use of different financial statements in the Form 10-K and the summary report is not, however, without risk. Although pooled financial statements do not contravene the antifraud provisions, improper comparisons between pooled and unpooled earnings could. See SEC Policy Statement on Conflicting Financial Reports and Earnings Computations, Exchange Act Release No. 8,336, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,567, at 83,196 (June 18, 1968) ("[I]t is misleading . . . to invite or draw conclusions as to improvement in a company's operations by comparing pooled figures for a particular year with unpooled figures for the prior year."). While accounting treatment need not match identically any divergence that renders the annual report misleading will violate the antifraud provisions. See Singhvi, *supra* note 79, at 351 (discussing Commission enforcement actions involving divergent and misleading accounting treatment in annual reports).

only did the omission of historical earnings substantially shorten the document, but it appears as if the annual report would seem less formidable to shareholders.

Although the summary annual report offers many benefits, its use does raise some concerns that merit discussion. First, the staff position was promulgated in two letters.¹⁴⁹ The position adopted in these letters could be reversed by either the staff or the Commission.¹⁵⁰ Given the compelling rationale supporting the use of summary reports, however, the small risk of reversal of the staff's position should not prevent use of the abbreviated format. Second, utilization of a summary annual report disrupts the status quo. An investment of substantial time, energy, thought, and creativity will be required for the summary annual report to provide an accurate overview of the company in an understandable fashion. The financial information normally consigned to the back of the report will need to be integrated throughout the document. The comfort of the essentially lock-step disclosure requirements contained in Rule 14a-3(b) will disappear.¹⁵¹

Use of a summary annual report requires one other important caveat. Issuers must make absolutely certain that the appendix to their proxy statement contains all of the information required by Rule 14a-3(b).¹⁵² The concept of a summary annual report is predicated upon the inclusion of all required information in the appendix to the proxy statement. With all of the necessary information contained in the appendix, companies have fulfilled their required disclosure obligations, thereby obtaining a free hand in drafting a summary report.

Issuers should, therefore, hesitate to use the 1987 McKesson summary report and proxy statement as a model. The McKesson appendix to the proxy statement inexplicably omitted required information. The appendix did not include the market price infor-

149. See *supra* note 11 and accompanying text.

150. See *supra* notes 14-16 and accompanying text.

151. See *supra* 128-29 and accompanying text.

152. Rule 14-3(b) requires the annual report to identify the company's executive officers and directors, indicate their principal occupation or employment, and provide the name and principal business of any organization employing the officer or director. 17 C.F.R. § 240.14a-3(b)(8) (1988). Including such information in the appendix is redundant because the information is required to appear in the body of the proxy. See Item 7, Regulation 14A, 17 C.F.R. § 240.14a-101 (1988). Nevertheless, with good reason, an issuer intending to treat the appendix as the annual report ought to include all of the information required by the rule, even if redundant. See *infra* note 158 and accompanying text.

mation required by Rule 14a-3(b)(9),¹⁵³ although the information was in the summary annual report. The appendix also did not undertake to provide a Form 10-K upon request.¹⁵⁴ Nor did the document contain the information on directors mandated by Rule 14a-3(b)(8).¹⁵⁵

By failing to make these disclosures, McKesson deviated from the factual representations made in its letter to the Commission staff. As a result, McKesson arguably lost the right to rely on the staff letter approving the proposed format.¹⁵⁶ Furthermore, McKesson, as a technical matter, contravened Rule 14a-3(b). Shareholders of the company never received a complete annual report. Nor does it matter that McKesson included the missing information in the summary annual report. Rule 14b-3(b) unequivocally contemplates that the company include all of the information in the annual report.¹⁵⁷ Any other interpretation would enable companies to inundate shareholders with a variety of documents, each containing a portion of the required disclosure, an untenable result. By failing to conform to Rule 14a-3(b), McKesson increased the company's exposure under the proxy rules.¹⁵⁸

C. No Annual Report

The most radical option available to issuers involves the complete elimination of a separate annual report. The GM/McKesson letters essentially took the position that the appendix to the proxy

153. 17 C.F.R. § 14a-3(b)(9) (1988).

154. MCKESSON CORP., PROXY STATEMENT (1987).

155. *Id.* McKesson represented in the letter that the appendix would contain all of the information required by Rule 14a-3(b). McKesson Corp., *supra* note 11. See 17 C.F.R. § 240.14a-3(b)(8) (1988).

156. Materially altering the facts as stated in a letter to the staff may render the staff opinion invalid. See *Beaumont v. American Can Co.*, 797 F.2d 79, 83 (2d Cir. 1986) (in seeking guidance from the SEC, a company may lose the protection of a no-action letter if the transaction is not conducted in the manner represented). See also Lemke, *supra* note 14.

157. 17 C.F.R. § 240.14b-3(b) (1988).

158. While McKesson's omissions seem insignificant, particularly in light of the simultaneous distribution of the information in the summary annual report, practical problems clearly arise. Annual reports to shareholders are integrated into the 1933 Securities Act and 1934 Exchange Act disclosure requirements. Often the report can be incorporated by reference into other documents. Failure to completely conform the appendix to the proxy to the edicts of Rule 14a-3(c) may subsequently prevent incorporation by reference. As a result of the failure, the appendix arguably ceased to qualify for the exemption from the proxy rules contained in Rule 14a-3(c). With the exemption unavailable, the document becomes subject to the antifraud provision in Rule 14a-9, thereby increasing the company's exposure for any misstatements. See *infra* notes 163-246 and accompanying text.

statement fulfilled all of the disclosure requirements of Rule 14a-3, thereby rendering the annual report superfluous.¹⁵⁹ As a result, under the reasoning of the letters, a company could eliminate the document entirely.¹⁶⁰

Nevertheless, some level of caution is required. A decision to dispense with the annual report requires the balancing of a number of competing factors. Factors supporting elimination of the annual report include its cost, its general ineffectiveness, and the lack of interest often evidenced by shareholders.

On the other hand, the document may enhance shareholder relations. Annual reports are a vehicle for keeping shareholders apprised of corporate developments while providing current information on the company's performance. This contributes to shareholder loyalty and satisfaction, which in turn, helps to maintain stock prices, encourage long-term ownership, and enhance shareholder loyalty in contests for control.¹⁶¹ Moreover, annual reports have residual value outside of the proxy process. They serve as an important promotional piece for distribution to investors throughout the year. Finally, the complaint of ineffectiveness can be overcome by a creative, well-drafted summary annual report.

A balancing of these competing interests suggests that elimination of the annual report will usually be disadvantageous, notwithstanding short-term cost savings. Elimination, however, may be proper when coupled with an alternative strategy for communi-

159. The Commission staff has previously indicated that a separate annual report need not be distributed if the proxy statement includes all of the information required by Rule 14a-3. Frier Industries, Inc., SEC No-Action Letter (Nov. 17, 1975)(LEXIS, Fedsec library, Noact file)("[T]his Division will not recommend any enforcement action to the Commission if a separate form of annual report is not furnished to security holders provided that the proxy statement contains all of the information and undertaking specified in subparagraphs 1 through 9 of Rule 14a-3."). Consistent with the letters to GM and McKesson, the staff apparently reasoned that insertion of the required information in the proxy fulfilled the mandates of Rule 14a-3, rendering the glossy annual report superfluous.

160. This statement reflects the views of the authors. See *supra* note 119. The NYSE requires the distribution of an annual report to shareholders and further requires that the report include financial statements. NEW YORK STOCK EXCHANGE, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 203.01 (1983). The rules, therefore, arguably limit the issuer's ability to dispense entirely with financial statements and/or annual reports. Nevertheless, the authors believe that the information contained in the appendix to the proxy statement should fulfill the NYSE annual report requirement.

161. See Sandler, *Heads of Some Big Companies Make Effort to Show Shareholders They Really Do Care*, Wall St. J., Feb. 19, 1987, at 55, col. 2 (noting that corporate efforts to improve shareholder relations are on the rise, in part because management "wants sympathetic holders in case it wants to make or resist an acquisition or raise capital").

cating with shareholders. For example, a company might complete a detailed and colorful report but decide against indiscriminate distribution.¹⁶² Under such a scheme, the annual report would be provided to shareholders upon request (perhaps through a postage paid card included in the proxy materials), replacing indiscriminate and ineffective distribution with a more focused mailing.

Alternatively, funds saved from the mailing of a standard annual report could be used to send communications to shareholders on a more frequent basis. In place of an annual, unread report, shareholders might receive instead frequent communications updating the company's performance. Whether such a strategy would be effective depends upon the particular company involved and the nature of its shareholders. Institutional investors that read and rely upon the Form 10-K might prefer continual updates in place of a once-a-year conventional annual report.

IV. ENFORCEMENT ISSUES

A. Background

As a result of the GM/McKesson letters, management now has an enhanced flexibility to communicate with shareholders through an annual report free of the formal strictures of the proxy rules. The newly-endorsed summary report is essentially an unregulated document. An issuer need not use one, and the style and content are left entirely to the discretion of management. Management can gauge the message it seeks to send to shareholders and then draft a direct, readable document suited to that purpose.

Of course, flexibility comes at a price. That price comes in the form of latent uncertainty over whether the summary annual report will implicate concerns under various provisions of the securities laws. The absence of form and content regulation makes

162. This approach would effectively recognize that not everyone has the same ability or inclination to digest information about the company. Rather than waste corporate assets through an indiscriminate mailing, the practice of including a return card would ensure that only those interested would receive the report. Notwithstanding the more limited distribution, the information in the report would still be in the public domain and reflected in stock prices. See Demmler, *Private Suits Based on Violation of the Proxy Rules*, 20 U. PITT. L. REV. 587, 598 (1959) (This article, written by a former chairman of the SEC, notes that most shareholders do not read proxy solicitation materials but that "analysts, investment advisors, conscientious brokers and dealers, institutional investors and intelligent individual investors do read proxy soliciting material concerning important transactions, and the composite opinion of those sophisticated people spreads, as gossip, through the 'Street' and influences other stockholders.").

the summary annual report analogous to a letter to shareholders, and like other such documents, subject to the proscriptions of the general antifraud provisions and perhaps even to the proxy rules.

B. The Proxy Rules

Conventional annual reports have always received special treatment under the proxy rules. Annual reports can clearly influence the proxy process,¹⁶³ and, to that extent, they come within the scope of the Commission's regulatory authority.¹⁶⁴ The proxy rules, however, exempted annual reports from some of the regulatory hazards that applied to other writings sent to shareholders.¹⁶⁵ Rule 14a-3(c) deemed an annual report not to be "filed" with the Commission,¹⁶⁶ rendering the express remedy in Section 18 of the Exchange Act¹⁶⁷ inapplicable.¹⁶⁸ Under Section 18, buyers and sellers who detrimentally relied on false or misleading statements in documents *filed* with the Commission could recover damages unless the filing person demonstrated good faith and a lack of knowledge that the statement was false or misleading.¹⁶⁹

More significantly, the proxy rules eliminated the annual report from the definition of "soliciting material."¹⁷⁰ In so doing, the

163. See generally Sommer, *The Annual Report: A Prime Disclosure Document*, 1972 DUKE L.J. 1093, 1101-02 (as long ago as 1942, the SEC sought to include the annual report within the definition of "proxy soliciting material").

164. SEC v. Okin, 132 F.2d 784, 786 (2d Cir. 1943) (Congressional regulation applies not only to a "proxy, power of attorney, consent or authorization" but also to other writings that are a part of a plan which ends in solicitation).

165. Sargent v. Genesco, Inc., 492 F.2d 750, 767-68 (5th Cir. 1974).

166. Rule 14a-3(c) provides that the "report is not deemed to be . . . 'filed' with the Commission" 17 C.F.R. § 240.14a-3(c) (1988).

167. See *supra* note 46.

168. 17 C.F.R. § 240.14a-3(c) (1988) ("The report is not . . . subject to . . . the liabilities of section 18 of the Act . . ."). Issuers can, however, voluntarily make Section 18 applicable either by specifically requesting that the report be considered part of the proxy soliciting materials or by incorporating the annual report by reference into the proxy statement.

169. Securities Exchange Act of 1934 § 18(a) (current version at 15 U.S.C. § 78r(a) (1986))(no liability if "the person sued shall prove that he acted in good faith and had no knowledge"). This exemption, however, is less significant in light of the expanded role that Rule 10b-5 plays in private civil actions. A private remedy exists under Rule 10b-5 for false or misleading statements in an annual report. See *Heit v. Weitzen*, 402 F.2d 909, 913-14 (2d Cir. 1968) (applying Rule 10b-5, court concluded that the plaintiffs satisfied the "in connection" requirement thus stating a valid cause of action), *cert. denied*, 395 U.S. 903 (1969).

170. Rule 14a-3(c) provides that the "report is not deemed to be 'soliciting material'" 17 C.F.R. § 240.14a-3(c) (1988).

rules effectively exempted the annual report — even one that otherwise would have fallen within the definition of “solicitation” in Rule 14a-1¹⁷¹ — from the strictures of the proxy rules, including the pre-filing requirements of Rule 14a-6,¹⁷² the timing provisions of Rule 14a-3(a),¹⁷³ and possibly the antifraud provisions of Rule 14a-9.¹⁷⁴ The rules drew the report into the full proxy process only if it “comment[ed] on or refer[red] to any solicitation.”¹⁷⁵ The

171. 17 C.F.R. § 240.14a-1 (1988).

172. 17 C.F.R. § 240.14a-6 (1988).

173. 17 C.F.R. § 240.14a-3(a) (1988).

174. 17 C.F.R. § 240.14a-9 (1988); *See* Malhas v. Shinn, 597 F.2d 28, 31 (2d Cir. 1979) (“ICC’s annual report was not proxy material the contents of which violated Rule 14a-9-4(a).”); *Leist v. American Bakeries Co.*, No. 80-1-2088 (N.D. Ill. Apr. 22, 1981) (LEXIS, Genfed library, Cases file) (“The Court concludes that the Company’s 1980 Annual Report is not soliciting material and is exempt from the provisions of Regulation 14A, including Rule 14a-9(a).”); *Markewich v. Adikes*, 422 F. Supp. 1144, 1146-47 (E.D.N.Y. 1976) (noting that the failure to correct an annual report does not violate Section 14(a)); *Dillon v. Berg*, 326 F. Supp. 1214, 1230 (D. Del.) (the annual report is exempted from liability under all of section 14’s rules except rule 14a-3), *aff’d*, 453 F.2d 876 (3d Cir. 1971). These cases do not consider whether an annual report comes within the antifraud provisions when it contains a direct comment on a proxy solicitation. *See* 17 C.F.R. § 240.14a-11(f) (1988). Since the exemption from the antifraud provisions recognized by these cases is based on the exemption in Rule 14a-3(c), the authors believe that an annual report that loses that exemption under 14a-11(f) would come within the antifraud provisions.

One court appears to have based liability under Rule 14a-9 on misstatements in the 14a-3 annual report. In *Gladwin v. Medfield Corp.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,013, at 97,536 (M.D. Fla. Jan. 30, 1975), *aff’d*, 540 F.2d 1266 (5th Cir. 1976), the court concluded that Medfield had violated Section 14(a) and Rule 14a-9 by failing adequately to disclose that it had incurred liability for refunds in connection with its participation in the Medicare program. The liability was sufficiently substantial to influence both past and present earnings. Yet the proxy statement referred to the liability only in a note to the consolidated financial statement in the annual report. The court, and the subsequent affirming court of appeals did not discuss the Rule 14a-3(c) exemption or the *Dillon* line of cases. *See also* 2 L. LOSS, SECURITIES REGULATION (2d ed. 1961).

Occasionally, however, the report to stockholders is so phrased that it is in fact supplementary proxy literature. In other words, although the report is not per se ‘soliciting material,’ the inclusion of material of that character in the report does not necessarily insulate it from the operation of the proxy rules.

Id. at 887-88.

175. Rule 14a-11(f), 17 C.F.R. § 240.14a-11(f) (1988). Read together, Rules 14a-3(c) and 14a-11(f) treat annual reports as exceptions to the otherwise expansive definition of “solicitation” under Rule 14a-1. Annual reports may, however, forfeit their safe harbor from the proxy rules. To the extent that an annual report touches on topics germane to the issue in a proxy statement, it may comprise “part of a continuous plan ending in [a] solicitation and which prepare[s] the way for its success.” *SEC v. Okin*, 132 F.2d 784, 786 (2d Cir. 1943) (holding a shareholder’s letter to other shareholders in anticipation of a proxy solicitation to be subject to the proxy rules). *See generally* *Long Island Lighting Co. v. Barbash*, 779 F.2d 793, 795-96 (2d Cir. 1985) (indirect communications placed in publications of general circulation may be subject to proxy rules if, in a chain of communications,

rules essentially treated the report as a purveyor of background information, and, although the rules regulated the timing of the report's distribution, the courts generally have imposed no duty to correct or clarify the contents of the document.¹⁷⁶

The exemption from the proxy rules for the conventional annual report is not an academic matter. Under Rule 14a-1, the term "solicitation" includes any "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."¹⁷⁷ A traditional annual report could amount to a communication reasonably — if not actually — calculated to result in procuring a proxy. The report may not mention the meeting or ask for a proxy, yet by touching on the matters germane to the meeting, may literally be part of a solicitation. Indeed, the Commission has acknowledged that annual reports may technically be part of a solicitation under the rules, but as a matter of policy, has treated them as having no direct connection with the proxy solicitation process.¹⁷⁸

they constitute a step designed ultimately to solicit proxies); *Brown v. Chicago, Rock Island & Pac. R.R.*, 328 F.2d 122, 125 (7th Cir. 1964) (public advertisement held not to be subject to the proxy rules where it was intended to inform the public rather than calculated to procure proxies). The Commission, however, opted for only a limited application of the rules to those annual reports which influenced the proxy process. As the issuing release for the first version of Rule 14a-11(f) explained:

For many years, the proxy rules have provided that the annual report, a copy of which must be furnished to security holders, is not deemed to be proxy material. As a result of the Commission's experience in a number of cases, the rules have been amended to provide that if any portion of the report is devoted to an attack or comment upon an opposition solicitation or opposition group, that portion of the report must be filed as proxy material in advance of publication.

Adoption of Amendments to Proxy Rules, Exchange Act Release No. 5,276, [1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,380, at 79,534-36 (Jan. 17, 1956).

176. See *Dillon v. Berg*, 326 F. Supp. 1214, 1229-31 (D. Del.), *aff'd*, 453 F.2d 876 (3d Cir. 1971).

177. 17 C.F.R. § 240.14a-1(K)(1)(iii) (1988).

178. The adopting release for the 1956 revision of the rules stated:

There was some concern expressed . . . that all semi-annual and quarterly reports and other communications containing information and comment concerning the business of the character normally sent to security holders by corporate management during the course of a fiscal year might be deemed to involve a solicitation and to be proxy material under the revised definition [of a solicitation]. This problem is not a new one and has previously existed under the rules. It is not the intention of the Commission and it is not the purpose of the amendments to subject such communications to the proxy rules In the ordinary case, it is not believed that this matter presents any real problem and the Commission has no desire to require the filing of the types of communications normally sent to security holders during the year.

Exchange Act Release No. 5,276, *supra* note 175, at 79,534.

An issuer, however, cannot lightly assume that the courts or the Commission will apply the exemption to summary annual reports.¹⁷⁹ The exemption from the proxy rules in Rule 14a-3(c) applies only to the full annual report required by Rule 14a-3(b); nothing in the rule or in the GM/McKesson letters implies that the summary annual report should enjoy similar protection. Without the comfort of the exemption provided by the rule, an issuer contemplating the summary annual report format must consider carefully whether the report will constitute the "solicitation" of a proxy.

In resolving the issue, the timing of the report may become crucial. The courts are understandably reluctant to deter "expedient reporting of significant developments that may affect the price of a corporation's stock."¹⁸⁰ This policy is counterbalanced, however, by the legitimate desire to restrict management's use of communications with shareholders to influence the proxy process.¹⁸¹ In balancing these competing interests, courts are less likely to draw the communication into the proxy regulation scheme, the longer the period of time between dissemination of the communication and the shareholder meeting.¹⁸²

179. As a voluntary communication subject to no formal restrictions, the summary annual report should receive treatment comparable to that accorded general communications such as shareholder letters. This will not, however, immunize the summary annual report from application of the proxy rules. *Sargent v. Genesco, Inc.*, 492 F.2d 750, 767-68 (5th Cir. 1974) (shareholder letter concerning refinancing plan held part of a solicitation thus triggering a cause of action under the proxy rules); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 600-01 (5th Cir.) (shareholder letter not part of solicitation), *cert. denied*, 419 U.S. 873 (1974). The principal factor that distinguished *Smallwood* was that the letter was issued soon enough after the agreement and long enough before the shareholder meeting for the court to conclude that the company had intended only to inform shareholders, not to influence their vote on the merger. Since distribution of a summary annual report would occur annually, rather than upon a significant corporate event, it is difficult to predict how a court might treat a report containing similar information. At least one case has held that an annual report not conforming with the requirements of Rule 14a-3(b) lost its immunity from the proxy rules. *Lynch v. Fulks*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,831, at 90,135 (D. Kan. Dec. 12, 1980). In *Lynch*, the defendant sent a letter to shareholders enclosing a proxy. He argued that the letter did not constitute a solicitation, because it was really an annual report and therefore exempt from the requirements of the proxy rules. In dispatching this argument, the court noted that "[u]nder Rule 14a-3(b) an exempt annual report must meet elaborate specifications that consume over two pages in the Code of Federal Regulations." *Id.* Because the letter failed the requirements of Rule 14a-3(b), the exemption granted annual reports was held unavailable.

180. *Smallwood*, 489 F.2d at 601.

181. See *infra* text at note 185.

182. See *Sargent*, 492 F.2d at 767 (letter sent at time of usual proxy solicitation period may be regulated by proxy rules); *Smallwood*, 489 F.2d at 601 (letter sent immedi-

Whether a summary annual report distributed before a proxy statement constitutes soliciting material will likely turn upon the issuer's purpose in sending the document.¹⁸³ To the extent that the document merely presents a condensed version of the financial and business matters contained in the Form 10-K or the Rule 14a-3(b) appendix to the proxy, the summary annual report is less likely to be treated by the courts as part of a "solicitation."¹⁸⁴ Where, on the other hand, a summary annual report comments directly or indirectly on significant issues at stake in the annual meeting — such as mergers, rights, plans, shareholder factions — the summary report may constitute a "solicitation." As one court noted in the context of a shareholder letter:

There are sound reasons for limiting the ability of interested parties to color the issues prior to the disclosure of complete information as required in a proxy statement. Without some restrictions, seeds of argument could be planted so deeply and securely prior to the time of formal proxy solicitation as to resist effectively later uprooting.¹⁸⁵

Courts, as well as the Commission, might regard an attempt to

ately after event occurred and well before stockholder meeting not regulated by proxy rules); *Brown v. Chicago, Rock Island & Pac. R.R.*, 328 F.2d 122, 125 (7th Cir. 1964) (advertisement published prior to the time any stockholder meeting was called or proxies solicited held not regulated by proxy rules).

183. *Long Island Lighting Co. v. Barbash*, 779 F.2d 793, 796 (2d Cir. 1985); *Studebaker v. Gittlin*, 360 F.2d 692, 696 (2d Cir. 1966); *Brown*, 328 F.2d at 125; *Data Probe Acquisition Corp. v. Datalab, Inc.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,451, at 96,577-78 (S.D.N.Y. Aug. 16, 1983); *Canadian Javelin Ltd. v. Brooks*, 462 F. Supp. 190, 194 (S.D.N.Y. 1978); *Kass v. Arden, Mayfair, Inc.*, 431 F. Supp. 1037, 1046 (C.D. Cal. 1977); *Chris-Craft Indus. v. Independent Stockholders Comm.*, 354 F. Supp. 895, 906 (D. Del. 1973).

184. Even a report that merely summarizes information otherwise available in the Form 10-K is not necessarily safe from scrutiny under the proxy rules. The Commission regulated the contents of the annual report precisely because it deemed the information important to shareholders in exercising their corporate franchise in an informed manner. See *supra* notes 20-75 and accompanying text. So, for example, if a report unfairly summarizes matters relevant to shareholder evaluation of management's performance, the authors doubt that the issuer could avoid application of the proxy rules' antifraud provisions.

185. *Smallwood*, 489 F.2d at 600. In *Smallwood*, the court ultimately concluded that the shareholder letter at issue there did not amount to a solicitation. The court concluded that the letter, which concerned a proposed merger, was disseminated so soon after the agreement and so long before the proxy solicitation process began that the letter was not "calculated to result in the procurement . . . of a proxy." *Id.* at 601. When compared with cases such as *Sargent*, 492 F.2d at 767-68, which concluded that a similar letter was a solicitation, *Smallwood* underscores the criticality assumed by timing issues when a summary annual report addresses topics that are later voted upon in a subsequent shareholders meeting.

communicate on such issues as merely an early step by management in a chain of communications culminating in the solicitation of a proxy.¹⁸⁶

The likelihood that the document falls within the definition of soliciting material is much stronger for a summary annual report distributed after the proxy statement but before the shareholder meeting. This period is the most sensitive; the time when the voting decision of shareholders can be readily influenced. Under such circumstances, even general comments about an issuer's financial condition may influence shareholders executing their proxy cards.¹⁸⁷

If a summary annual report does constitute solicitation material, it becomes subject to the same timing and filing requirements as shareholder letters and other supplemental communications. Unlike the annual report contemplated by Rule 14a-3(b), soliciting materials must be filed with the Commission at least two days before distribution.¹⁸⁸ That filing can form the basis for liability under Section 18 of the Exchange Act.¹⁸⁹ Unlike the annual re-

186. *Long Island Lighting Co.*, 779 F.2d at 796. Press releases and shareholder letters touching on proxy-related subjects have been successfully challenged under the proxy antifraud rules. *Sargent*, 492 F.2d at 767-68; *Dynamics Corp. of Am. v. CTS Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,765 (N.D. Ill. May 3, 1986); *Transworld Corp. v. Odyssey Partners*, 561 F. Supp. 1315, 1320 (S.D.N.Y. 1983). See generally *Studebaker Corp.*, 360 F.2d at 692; *SEC v. Okin*, 132 F.2d 784, 786 (2d Cir. 1943)("[H]is statement, if the facts were as alleged, was none the less untrue, and should not have been made.").

187. To be sure, Section 14 was not intended to subject every management communication with shareholders to intense scrutiny. *Issen v. GSC Indus.*, 508 F. Supp. 1278, 1294 (N.D. Ill. 1981)("[S]ection 14 was not intended by Congress to subject every informational communication by management to shareholders to stringent scrutiny."). Nevertheless, a communication discussing topics that bear on the subject of the meeting risks the court's searching examination. See *SEC v. McQuiston*, 5 S.E.C. Jud. Dec. 332, 333-34 (S.D.N.Y. 1947)(management letter that informed shareholders of a delay in mailing of the proxy statement became part of the solicitation because it contained a characterization of the position held by the opposing faction in the proxy contest). Nor will the fact that the communication is styled as an annual report, whose contents are tailored to include only the required items of Rule 14a-3(b), conclusively set it outside the proxy rules. At least one court has found a management communication to constitute part of a solicitation even though the information contained therein was compulsory. See *Dataprobe Acquisition Corp. v. Datalab, Inc.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,451, at 96,577-78 (S.D.N.Y. Aug. 16, 1983)(management's comments concerning a tender offer, required by Rule 14e-2, 17 C.F.R. § 240.14e-2 (1988), held part of the solicitation of proxies).

188. The filing provisions of Rule 14a-6 require that soliciting material be filed with the Commission two days before being sent to shareholders. 17 C.F.R. § 240.14a-6(b) (1988).

189. See *supra* text accompanying notes 166-69.

port contemplated by Rule 14a-3(b),¹⁹⁰ which must reach shareholders prior to or contemporaneously with the proxy statement, Rule 14a-6¹⁹¹ requires that a solicitation must reach shareholders after they receive the proxy statement. Thus, to the extent that the content of the summary annual report can be construed as a "solicitation," an issuer risks application of the full panoply of regulatory requirements contained in the proxy rules.¹⁹²

C. Antifraud Concerns

The applicability of the timing and pre-filing provisions, even the status of the document as "filed" for purposes of Section 18, present cumbersome but not insurmountable problems. Of greater concern, however, is the applicability of the antifraud provisions to the summary annual report. The GM/McKesson letters¹⁹³ themselves indicate that the summary annual report remains subject to the antifraud provisions. The letters, however, do not specify all of the provisions which might apply. The status of the summary annual report under particular antifraud provisions therefore remains unclear.

1. Rule 14a-9

Perhaps the most critical issue concerns the applicability of Rule 14a-9.¹⁹⁴ In the GM/McKesson letters, the staff implied that the annexing of the financial information required by Rule 14a-3(b) substantially satisfied the regulatory concerns that prompted the regulation of the contents of the report in the proxy rules.¹⁹⁵ Moreover, the GM letter states only that the antifraud provisions would apply to the summary report because such reports "can reasonably be expected to affect the market for the corporation's securities."¹⁹⁶ With no mention of untoward impact on voting rights, this statement implies that the staff views the

190. 17 C.F.R. § 240.14a-3(b) (1988).

191. 17 C.F.R. § 240.14a-6(b) (1988).

192. Moreover, courts have held that a private right of action exists for violation of the timing and pre-filing provisions contained in the proxy rules. *See supra* note 169.

193. *See supra* note 11.

194. 17 C.F.R. § 240.14a-9 (1988). A separate antifraud provision, Rule 14c-6, governs information statements. 17 C.F.R. § 240.14c-6 (1988). Discussions of the proxy antifraud provisions in this article, however, will focus exclusively on Rule 14a-9.

195. *See text at supra* notes 99-109.

196. General Motors Corp., *supra* note 11, at 77,311. *See also supra* text accompanying note 106.

principal antifraud concerns as arising not under the proxy rules but rather under the general antifraud provisions of Rule 10b-5.

Once again, however, this analysis depends in part on the contents and characterization of the summary report. Just as a summary report that falls within the definition of solicitation will trigger the timing and filing requirements of Rule 14a-6,¹⁹⁷ it will also trigger the antifraud provisions of Rule 14a-9.¹⁹⁸ The applicability of this rule raises important concerns. As with other antifraud provisions, Rule 14a-9 prohibits false or misleading disclosure.¹⁹⁹ Unlike the ubiquitous Rule 10b-5,²⁰⁰ however, the proxy antifraud provision does not require proof of scienter; simple negligence will suffice.²⁰¹ Moreover, while other antifraud provisions — particularly Section 17 of the Securities Act²⁰² — preserve a negligence standard for recovery,²⁰³ doubts exist about a private right of action under those provisions.²⁰⁴ Rule 14a-9 poses

197. See *supra* notes 191-92 and accompanying text.

198. See, e.g., *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974). In *Sargent*, the letter to shareholders that was held to have violated Rule 14a-9 inaccurately described a refinancing plan on which shareholders were not even being asked to vote. *Id.* at 766-68. See also *Dynamics Corp. of Am. v. CTS Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,765, at 93,748-49 (N.D. Ill. May 3, 1986) (holding that a misleading press release violated Rule 14a-9).

199. 17 C.F.R. § 240.14-9(a) (1988).

200. 17 C.F.R. § 240.106-5 (1988).

201. See *Gould v. American-Hawaiian Steamship*, 535 F.2d 761, 777 (3d Cir. 1976) (negligence is the appropriate standard under § 14(a)); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1300-01 (2d Cir. 1973) (In Rule 14a-9 action plaintiffs "are not required to establish any evil motive or even reckless disregard of the facts"); *Fradkin v. Ernst*, 571 F. Supp. 829, 843 (N.D. Ohio 1983) ("negligence standard should apply to the corporation issuing the proxy statement"). The Sixth Circuit has required scienter in a 14a-9 action, but only in connection with the liability of corporate outsiders. *Adams v. Standard Knitting Mills*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

202. Securities Act of 1933, Section 17 (current version at 15 U.S.C. § 77q (1986)).

203. *Aaron v. SEC*, 446 U.S. 680 (1980) (scienter not required for subsections (a)(2) and (a)(3) of Section 17); *Design Time, Inc. v. Synthetic Diamond Technology*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,634 (N.D. Ind. Oct. 13, 1987).

204. Some circuits have concluded that no private right of action exists under the section. *Currie v. Cayman Resources*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,591 (11th Cir. Jan. 12, 1988); *Landay v. All American Assurance Co.*, 688 F.2d 381, 384 (5th Cir. 1982); *Shull v. Dain Kalman & Quail Inc.*, 561 F.2d 152 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978). Other circuits disagree and have found an implied right. *Schimmel v. Strategic Oil Leasing Partners*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,560 (D. Ore. May 28, 1987); *Richey v. Westinghouse Credit*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,586 (W.D. Okla. Dec. 29, 1986); *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978), *cert. denied*, 442 U.S. 909 (1979); *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975). The Supreme Court has expressly declined to decide the question on at least two occasions. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.2 (1983) ("We have previously reserved deci-

no similar uncertainty.²⁰⁵

The specter of Rule 14a-9 liability constitutes an important consideration when deciding whether to issue a summary annual report. This is especially true in the context of a proxy contest or an annual meeting that will raise a significant corporate event such as a merger or rights plan. While doubt may exist as to the applicability of Rule 14a-9 to a traditional Rule 14a-3(b) annual report,²⁰⁶ no such doubt would arise for summary annual reports falling within the definition of soliciting material. Unlike the traditional Rule 14a-3(b) annual report, the summary annual report would probably receive the treatment under the rules accorded to press releases, shareholder letters and other communications issued during the course of a proxy solicitation.²⁰⁷

2. General Antifraud Provisions of Rule 10b-5

Rule 14a-9 does not represent the only hurdle issuers of a summary annual report must confront. An issuer must also consider whether a summary annual report will be compatible with the general antifraud provisions. The GM/McKesson letters expressly refer to the possibility of liability under Section 17 of the 1933 Act²⁰⁸ and Rule 10b-5 of the Exchange Act.²⁰⁹

At first blush, the need to reference the antifraud provisions

sion on whether § 17(a) affords a private remedy . . . and we do so again.”); *Aaron v. SEC*, 446 U.S. 680, 689 (1980) (“this Court . . . has not had occasion to address the question whether a private cause of action exists under § 17(a).”). The weight of authority is clearly against a private right of action. Indeed, in 1987, the Ninth Circuit overruled two prior panel opinions that had found a private right of action. *See In re Washington Pub. Power Supply Sys. Sec. Litig.*, 823 F.2d 1349 (9th Cir. 1987)(en banc)(Judge (now Supreme Court Justice) Kennedy participated in the case and supported the majority opinion). *See also Newcome v. Esrey*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 94,106 (4th Cir. Dec. 16, 1988)(en banc)(no private right of action under Section 17(a)).

205. *J.I. Case Co. v. Borak*, 377 U.S. 426, 430-31 (1964)(finding a private right of action under Rule 14a-9). Similar results obtain regarding the existence of private rights of action under the other various SEC rules adopted pursuant to Section 14 of the Securities Act. *See Rauchman v. Mobil Corp.*, 739 F.2d 205, 208 (6th Cir. 1984)(private right of action under Rule 14a-8); *Haas v. Wieboldt Stores*, 725 F.2d 71, 73 (7th Cir. 1984)(private right of action under Rule 14a-7); *Ash v. GAF*, 723 F.2d 1090, 1092 (3rd Cir. 1983)(private right of action under Rule 14a-3). The issue is so settled that one court characterized the argument that a private right of action did not exist under Rule 14a-6 as “unbelievably specious.” *Lynch v. Fuls*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,831 (D. Kan. Dec. 12, 1980).

206. *See supra* notes 170-78 and accompanying text.

207. *See supra* notes 179-92 and accompanying text.

208. *See supra* note 203.

209. *See supra* note 47.

may appear puzzling. Annual reports can certainly give rise to liability under either the Rule 14a-9²¹⁰ or Rule 10b-5.²¹¹ A Rule 14a-3 annual report, however, has substantial overlap with the Form 10-K.²¹² The conventional annual report, therefore, does not generally present antifraud issues distinct from the report filed on Form 10-K. Moreover, at least one court has opined that only the Form 10-K filing actually triggers the application of Rule 10b-5.²¹³

The new summary report, however, will presumably not have as substantial an overlap with the contents of the Form 10-K. By design, a summary annual report conveys a simpler, more direct message than the material presented in the Form 10-K. The summary annual report will condense or omit completely the more detailed information typically included in the Form 10-K and the proxy statement. This condensation and simplification of disclosure will inevitably raise concerns of completeness and accuracy. These concerns will be particularly acute when the summary annual report is distributed prior to the proxy statement and Form 10-K.

An issuer can reduce the risk of liability by disseminating the Form 10-K prior to the mailing of the summary annual report. Nevertheless, an accurate Form 10-K will not obviate liability for a false summary report. A report that is patently false will generate liability even if the issuer makes accurate disclosure through other means. The more complete disclosure available to the market in the full report will likely raise an insurmountable obstacle to allegations of materially incomplete summary reports, particularly to fraud allegations based upon a "fraud on the market" theory.²¹⁴ So long as full and accurate disclosure is available to secur-

210. See *supra* note 174 and accompanying text.

211. *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968) (annual report may give rise to Rule 10b-5 liability), *cert. denied*, 395 U.S. 903 (1969). See also *In re Apple Computer Sec. Litig.*, 672 F. Supp. 1552, 1564-65 (N.D. Cal. 1987) (statement taken from an annual report found not misleading and thus not violative of general antifraud provisions).

212. See *supra* notes 64-74 and accompanying text.

213. *SEC v. Benson*, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1987). Regarding proxy materials, the *Benson* court suggested that they might fail the "in connection with" requirement imposed under Section 10(b) and Rule 10b-5. *Id.*

214. The "fraud on the market" or "integrity of the market" theory posits that market participants need not demonstrate their reliance on fraudulent statements in publicly filed documents such as registration statements and annual reports to state a cause of action under the antifraud provisions of the federal securities laws. The theory rests on the notion that the market has relied on the false information in setting the price for the securities. See *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S.

ities analysts and market participants, plaintiffs may have considerable difficulty demonstrating that the summary annual report adversely affected the price of the security.

If the summary annual report reaches the market before the fuller disclosure of the Form 10-K report and proxy statement, the completeness and accuracy of the summary report is likely to be examined with more exacting scrutiny. Without full and accurate disclosure in the securities market, an issuer runs the risk of affecting the market in its securities on the basis of an informal and summary document. Prudence dictates that the more risk-prone summary document should be distributed only after circulation of the less readable, highly regulated, defensively drafted Form 10-K and proxy statement.²¹⁵

Incomplete or inaccurate statements in a summary annual report — for the purposes of both Rule 14a-9 and Rule 10b-5 liabil-

1102 (1983); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975). See generally Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982) (the fraud-on-the-market presumption of reliance should be applied only in developed markets, where the efficient market hypothesis will most likely hold true). The Supreme Court explained the rationale for the theory:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business, misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements

Basic, Inc. v. Levinson, 108 S. Ct. 978, 988-89 (1988)(quoting *Peil v. Spreiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

215. Of course, the degree to which the antifraud provisions ensure adequate disclosure is unclear. Municipal bonds are exempt from registration under the Securities Act of 1933. Securities Act of 1933 § 3(a)(2)(current version at 15 U.S.C. § 77c(2) (1986)). As such, the content of a bond circular is not governed by the affirmative line item disclosure requirements in Regulation S-K, but is subject to the requirements of the antifraud provisions. See *Brown, Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741 (1985)(discussing affirmative disclosure obligations imposed by the antifraud provisions). Recent lawsuits and investigations suggest that the disclosure in bond circulars has often been inadequate. See *Wells, Tiny Matthews & Wright is Center of Big Litigation*, *Wall St. J.*, Sept. 1, 1987, at 6, col. 1; see also *Forbes & McGrath, Disclosure Practices in Tax-Exempt General Obligation Bonds: An Update*, 7 MUN. FIN. J. 207, 208 (1986) (Authors conducted a survey of disclosure in official statements of tax-exempt general obligation bonds. The results indicated disclosure to investors has increased. In the context of the summary annual report, however, the antifraud provisions may provide greater assurance of adequate disclosure. The offering circular for bonds may contain the only public information about the bonds and the use of the bond proceeds. A summary annual report, however, will only be one of many disclosure documents issued by a publicly traded company. These other documents — particularly periodic reports, proxy statements and registration statements — are subject to affirmative disclosure requirements and presumably will ensure that the public has adequate information about an issuer.

ity — are analyzed according to their effect on the “total mix” of information available to shareholders.²¹⁶ The greater the variety and depth of information available on the subject, the more persuasively management can argue that any statements in a summary annual report were not materially false or misleading.

3. Projections

One area of obvious risk concerns the use of projections and other forward looking statements in summary annual reports. As any issuer knows, projections can provide prospective investors with valuable information and assist market professionals in their analysis of a company's prospects. At the same time, disclosure of projections is fraught with risk. Attempts to forecast the future often prove incorrect. Disgruntled shareholders often attempt to use incorrect projections to obtain damages under the antifraud provisions.²¹⁷ While often unsuccessful, such suits have a habit of surviving motions to dismiss and other attempts at early stages to arrest their progress.

Aware of the value of forward looking information, the Commission has adopted a safe harbor rule designed to reduce management's exposure to liability for projections that ultimately prove incorrect. Any projection meeting the requirements of Rule 175²¹⁸ will not be deemed fraudulent unless made in bad faith or without a reasonable basis.²¹⁹ The rule also shifts to plaintiffs the burden of establishing bad faith or unreasonable basis.²²⁰

The safe harbor rule applies only to projections appearing in

216. *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988); *see also* *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (An omitted fact will be considered material under Rule 14a-9 if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”).

217. *See Eisenberg v. Gagnon*, 766 F.2d 770, 775 (3d Cir.) (“There is considerable authority that projections, forecasts and opinions are actionable as misleading in a variety of circumstances.”), *cert. denied*, 474 U.S. 946 (1985); *Goldman v. Belden*, 754 F.2d 1059, 1069 (2d Cir. 1985) (“Given defendants’ positive predictions and the allegations of knowledge of the undisclosed negative factors . . . we conclude that the Complaint adequately stated a claim under § 10(b) and Rule 10b-5.”).

218. 17 C.F.R. § 230.175 (1988). The value of Rule 175 as a safe harbor has been questioned. *Brown*, *supra* note 215, at 796; *see also* *Jackson v. Daniels* [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,045 (D.N.M. Apr. 12, 1985) (bank holding company could not rely on Rule 175 for alleged misrepresentations and omissions about projected loan loss reserves).

219. 17 C.F.R. § 230.175(a) (1988).

220. 17 C.F.R. § 230.175(b)(1) (1988).

certain Commission filings, including annual reports meeting the requirements of Rule 14a-3.²²¹ Since a summary report does not meet the requirements of the Rule, projections inserted only in the abbreviated report will not receive the protections of the safe harbor. A simple way to gain the Rule's protection would be to include the projection in the appendix to the proxy statement and repeat it in the summary report. Under Rule 175, a projection in the summary annual report will fall within the safe harbor if repeated in a quarterly report, annual report to shareholders, or any other document "filed" with the Commission.²²²

4. Section 12 of the 1933 Act

As the previous discussion indicates, the summary annual report raises concerns under the antifraud provisions typically not present with more conventional, glossy annual reports. Yet in at least one instance, use of the abbreviated report will materially reduce the prospect of liability under the securities laws. Issuers meeting certain eligibility requirements may register securities on Form S-2.²²³ Reflecting acceptance of the efficient market theory,²²⁴ the form permits issuers to incorporate into the registration statement extensive information from previously filed documents.²²⁵ With respect to information contained in the annual report to shareholders, however, issuers using Form S-2 must either repeat the information in the registration statement or distribute the most recent annual report along with it.²²⁶

221. 17 C.F.R. § 230.175(b) (1988). *See also* Safe Harbor Rule for Projections, Securities Act Release No. 6,084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979) ("Statements made outside of these documents will be covered by the rule only if they are included in documents filed with the Commission or . . . in annual reports to shareholders meeting the requirements" of Rules 14a-3 or 14c-3.).

222. 17 C.F.R. § 230.175(b)(1) (1988).

223. The general instructions for the form limit its potential users to those issuers who have been subject to the periodic reporting requirements for at least three years, filed all required reports for the prior twelve months in a timely fashion and did not, within the past year, fail to pay a dividend on preferred stock or default on certain payments. 17 C.F.R. § 239.12 (1988).

224. *See* Reproposal of Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 6,331 (Aug. 6, 1981), 46 Fed. Reg. 41,904 [hereinafter Securities Act Release No. 6,331](Form S-3 "is predicated on the Commission's belief that the market operates efficiently for these companies, i.e., that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated and accounted for by the marketplace.").

225. 17 C.F.R. § 239.12 (1988).

226. *Id.* The Commission apparently permitted distribution of the annual report with

Although convenient, distribution of annual reports with the registration statement on Form S-2 raises the specter of liability under the 1933 Act. Section 11 of the Act²²⁷ permits actions for rescission or damages for misstatements contained in an effective registration statement. Apparently in an effort to minimize the applicability of Section 11 liability to annual reports, the instructions to Form S-2 allow issuers to designate the portions of the report that will not become "part of" the registration statement.²²⁸ Outside the registration statement, the designated provisions of the annual report are presumably not subject to Section 11.²²⁹

The practical effect of the instructions to Form S-2 is to permit issuers to keep out of the registration statement the narrative portion of the annual report (*i.e.*, the part of the annual report most likely to contain hyperbole and other statements that might be the basis for a suit under Section 11).²³⁰ Whatever insulation from liability under Section 11 is provided by the instructions, Section 12(2) remains an unaddressed concern.²³¹ A misleading statement in the portion of the report not incorporated by reference into the registration statement may be actionable under Section 12(2).²³²

Section 12(2) imposes liability not only for misleading statements in a registration statement, but also for any misleading statements or omissions made in connection with the offer or sale of securities. Section 12, therefore, would impose liability for any

the prospectus as a cost reduction measure. *See* Securities Act Release No. 6,331, *supra* note 224, at 41,916 ("The Commission believes, however, that the option of annual report delivery provides registrants the opportunity to take advantage of an existing document to effect registration cost savings where appropriate, particularly since, as the form indicates, a legible facsimile of the annual report may be used.").

227. Securities Act of 1933 § 11 (current version at 15 U.S.C. § 77k (1986)).

228. Item 12(b), Form S-2, 17 C.F.R. § 239.12 (1988)("[T]he registrant may also state, if it so chooses, that specifically described portions of its annual or quarterly report to security holders, other than those portions required to be incorporated by reference pursuant to paragraphs (a), (3) and (4) above, are not part of the registration statement.").

229. While that seems to be the clear import of the Form, whether a court would necessarily agree is another question.

230. *See In re Apple Computer Sec. Litig.*, 672 F. Supp. 1552, 1562-63 (N.D. Cal. 1987)(allegations that letter to shareholders in annual report was misleading under Rule 10b-5).

231. Securities Act of 1933 § 12(2)(current version at 15 U.S.C. § 77l(2) (1986)). Some have expressed concern over the specter of liability under Section 12(2) for those portions of the annual report not incorporated into the registration statement. *See* Matrix Corp., SEC No-Action Letter (June 30, 1983)(LEXIS, Fedsec library, Noact file).

232. This statement reflects the views of the authors. *See supra* note 119.

misleading statement in an annual report distributed with the registration on Forms S-2, including the narrative and other portions specifically excluded from the registration statement. Section 12(2) has a broad reach with coverage extending not only to direct sellers, but also to those participating in the sale.²³³ Section 12(2) provides a single defense: that in the exercise of reasonable care, the seller "could not have known" about the misstatement.²³⁴

Liability under Section 12(2) could be minimized by using a summary annual report. The required disclosure would be included in the appendix to the proxy statement,²³⁵ with the narrative discussion and other hyperbole moved to the summary annual report. A registrant using Form S-2 could circulate the appendix to the proxy with the Form S-2 registration statement, thereby disassociating the narrative from the offering process.²³⁶

D. Registration Concerns

Gun jumping is another possible concern with the use of sum-

233. Courts have generally held lawyers and banks liable as sellers only where they were "substantial participants" in the illegal sales. To be a "substantial participant" required something more than routine involvement. Ordinary activities such as preparing documents or lending money were not enough. *See, e.g., FSLIC v. Proud Excelsior Ltd.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,754 (D. Utah Apr. 24, 1987) (bank acting as trustee for bonds that provided routine services not liable under Section 12(2) as seller). Instead, courts looked for additional factors such as direct participation in the sales effort or supervising the scheme. The Supreme Court, however, recently adopted a somewhat different test. *See Pinter v. Dahl*, 108 S. Ct. 2063 (1988) (although interpreting Section 12(1), the court's analysis bearing on the issue discussed herein would apply as well to Section 12(2)). The Court in *Dahl* rejected the contention that the term "seller" extended no farther than the person who actually transferred title. Instead, the Court held that the term extended to anyone "who solicit[s] securities purchases." *Id.* at 2078. Recognizing the breadth of the test, the Court went on to conclude that a person soliciting sales also had to benefit from the transaction. "The language and purpose of § 12(1) suggest that liability extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Id.* at 2079. The Court characterized the "substantial participant" test as overly broad. As a technical matter the court in *Dahl* construed the definition of the term "seller" only for purposes of Section 12(1). *Id.* at 2076 n.20. It seems unlikely that the definition could be different for Section 12(2). Nevertheless, it is conceivable that the older "substantial participant" test, of Section 12(2) could survive *Dahl*. Practitioners are thus required to work with both standards pending further guidance from the court.

234. Securities Act of 1933 § 12(2) (current version at 15 U.S.C. § 77i(2) (1986)).

235. This statement reflects the views of the authors. *See supra* note 119.

236. Registrants not using Form S-2 may also be affected because a registration statement incorporating by reference any portion of the annual report to shareholders must contain an undertaking to supply the report upon request. Item 512(e) of Regulation S-K, 17 C.F.R. § 229.512 (1988). To the extent the annual report is sent prior to the sale, the document seems subject to the proscriptions of Section 12(2).

mary annual reports. Absent an exemption, Section 5 of the 1933 Act²³⁷ prohibits the offer or sale of securities prior to the filing of a registration statement.²³⁸ "Offer" has been interpreted broadly to include disclosures that condition the market in advance of a public offering.²³⁹ Promotional materials designed to stimulate public interest in, and awareness of, a company may thus constitute an illegal offer under Section 5.²⁴⁰ Once a registration statement has been filed, but before the effective date, written offers may be made only through a prospectus conforming with the requirements of Section 10.²⁴¹ The definition of "prospectus" includes "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."²⁴² As a result, any written disclosure made after the registration statement has been filed may be characterized as a prospectus in violation of Section 5.²⁴³

The Commission has issued at least four releases designed to

237. Securities Act of 1933 § 5 (current version at 15 U.S.C. § 77e (1982)).

238. Section 5(c) prohibits an "offer to sell or offer to buy" securities prior to the filing of a registration statement. 15 U.S.C. § 77e(c)(1982). Section 5(a) prohibits the sale of securities absent an effective registration statement. 15 U.S.C. § 77e(a) (1982).

239. Publication of Information Prior to or After Effective Date of Registration Statement, Securities Act Release No. 3,844, 1 Fed. Sec. L. Rep. (CCH) ¶ 3,250 (Oct. 8, 1957). The Commission explained:

It apparently is not generally understood, however, that the publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.

Id. at 3,149. See also *SEC v. Commercial Inv. & Dev.*, 373 F. Supp. 1153, 1164 (S.D. Fla. 1974) (holding that a newsletter and a letter authored by the company president constitute an illegal offer); *SEC v. Firestone Group*, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,728, at 99,191 (D.D.C. 1970) (holding that promotional seminars preconditioning the market constitute an illegal offer); *SEC v. Arvida Corp.*, 169 F. Supp. 211, 215 (S.D.N.Y. 1958) (press releases announcing company's assets, future projects, and a public offering that would occur within 60 days deemed an illegal offer in violation of Section 5(c)). See also *Brown*, *supra* note 215, at 809.

240. Securities Act of 1933 § 5(b)(2) (current version at 15 U.S.C. § 77e(b)(2) (1986)).

241. Section 10 requires a prospectus to disclose certain information, including information about the issuer's business, assets, and financial condition. Securities Act of 1933 § 10 (current version at 15 U.S.C. § 77(j)(1986)).

242. Securities Act of 1933 § 2(10) (current version at 15 U.S.C. § 776(10) (1986)).

243. See *SEC v. Commercial Inv. & Dev. Corp.*, 373 F. Supp. 1153, 1164-65 (S.D. Fla. 1974) (concluding that a newsletter and a report made public were invalid prospectuses).

clarify the boundaries of permissible disclosure during the black-out period.²⁴⁴ During the black-out period, the Commission has generally encouraged companies to refrain from unnecessary disclosures that may violate the securities laws. A company, however, may make disclosures that would typically occur in the ordinary course of business. Accordingly, a company can continue to respond to unsolicited inquiries from shareholders, advertise products, send customary reports to shareholders, and issue press releases with respect to factual matters and financial developments.²⁴⁵ The emphasis is on ordinary prior conduct. If a company has historically not engaged in certain types of activities, such as advertising, the sudden implementation of an advertising program during the black-out period may violate Section 5.

Distribution of an ordinary annual report during the black-out period will not violate Section 5. This is true even where the report is distributed to prospective investors and other non-shareholder groups. The report must, however, be of the same general "character and content" as those reports issued in prior years.²⁴⁶

The use of a summary report during the black-out period may raise concerns. The use of the more flexible format for the first time during the black-out period may suggest market conditioning. Even if the summary report had been used previously, the reduced regulation under the proxy rules of the document's contents may provide greater opportunities for incendiary comments that could be construed as influencing the offering process. At a

244. Statement of the Commission Relating to Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 3,844 (Oct. 4, 1957). 22 Fed. Reg. 8359; Guidelines for the Release of Information by Issuers Whose Securities Are in Registration, Securities Act Release No. 5,180, 1 Fed. Sec. L. Rep. (CCH) ¶ 3,056 (Aug. 16, 1971); Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933, Securities Act Release No. 5,009, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,744 (Oct. 7, 1969); Offers and Sales of Securities by Underwriters and Dealers, Securities Act Release No. 4,697, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 3257-3260 (June 5, 1964).

245. Securities Act Release No. 5,180, *supra* note 245. See also *In re Carl M. Loeb, Rhoades & Co.*, Exchange Act Release No. 5,870, [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,635 (Feb. 9, 1959) ("This flow of normal corporate news, unrelated to a selling effort for an issue of securities, is natural, desirable and entirely consistent with the objective of disclosure to the public which underlies the federal securities laws.").

246. The Harper Group, SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,631, at 80,631-32 (May 3, 1976) ("[T]his Division will not recommend any enforcement action . . . provided that the annual report is of the character and content normally published by the company and does not contain material designed to assist in the proposed offering.").

minimum, the report should be drafted with added care and reduced hyperbole.

CONCLUSION

The GM/McKesson letters have suddenly acceded to management a huge, almost frightening amount of discretion in connection with the annual report. Threshold questions of whether to distribute an annual report at all, and if so, whether to use the summary report format must be asked and answered. Those opting for the summary annual report must then determine the format and content that works best for them and their shareholders.

Decisions about the summary annual report ought to encourage the re-examination *in toto* of the shareholder communication process. With the adoption of the shareholder communication rules, companies can now obtain the identity of non-objecting beneficial owners and communicate directly with these shareholders.²⁴⁷ Direct communication will reduce costs, save time and permit communication on a more frequent basis.

Companies may therefore want to implement a shareholder relations strategy that involves an informative summary annual report and more frequent communication, particularly updates about corporate developments. Communications no longer need to be wooden recitations of current developments. Use of a summary annual report allows management to make shareholder communications informative, frank, and engaging. For example, shareholders might be apprised of new product developments. Given the competition for aisle space in grocery stores, consumer food manufacturers may want to encourage brand loyalty and demand among shareholders. Communications to shareholders might include discount coupons or other inducements. Shareholders then will learn of new products and new marketing strategies, and will be personally invited to participate.²⁴⁸

247. 17 C.F.R. § 240.14a-13 & .14c-7 (1988).

248. One problem with an advertising campaign directed toward shareholders concerns restrictions in the proxy rules on the use of lists of non-objecting beneficial owners. The lists may only be used for purposes of shareholder communications. Specifically, the Commission has indicated that it is a misuse of a shareholder communication to seek increased product sales. Facilitating Shareholder Communications, Exchange Act Release No. 23,847, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,046, at 88,358 (Nov. 5, 1986) ("Use of beneficial owner lists for product sales is not permitted."). To circumvent the restriction, companies could mail corporate communications in which product sales constituted only an incidental part. Given the overriding purpose of communicat-

Constant, informative, honest communication from management may enhance shareholder loyalty, a valuable commodity in an era of hostile acquisitions. Likewise, companies can use effective communications as a way to enhance their community standing and increase business. Smaller bank and thrift holding companies often draw sizable amounts of business from particular communities. Moreover, stock ownership will often be concentrated in the same community. Effective communications strengthen both shareholder relations and standing within the community.

In the long run, the flow of communications may be increasingly two-way. Shareholders may be encouraged to communicate their reactions to various changes of management. Perhaps comment may be encouraged on esoteric corporate strategies such as a possible reorganization or anti-takeover charter amendments.²⁴⁹ Shareholders may also be invited to comment on new products or advertising campaigns.

In any event, the new flexibility provided by the use of a summary annual report means that strategy decisions concerning corporate communication, including the type of communication and content, are not controlled by legal concerns but by business considerations. Lawyers should review communications for conformity with the ubiquitous antifraud provisions but otherwise play a minimal role in this new process.

ing with shareholders, no violation would seem to have occurred.

249. Of course, care would have to be taken that the request for comment does not amount to a solicitation under Rule 14a-1. A solicitation would trigger the full panoply of requirements under the proxy rules. *See* 17 C.F.R. § 240.14a-2 (1988).

